Executive MBA
Mergers & Acquisitions

A view into the Private equity industry. The Austrian capital market and its influence on the Austrian private equity Market.

A Master's Thesis submitted for the degree of
"Master of Business Administration"

supervised by

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Vienna, August 2010

Affidavit

I, **ERICH SANDBERG**, hereby declare

1. that I am the sole author of the present Master's Thesis, "A VIEW INTO THE PRIVATE EQUITY INDUSTRY. THE AUSTRIAN CAPITAL MARKET AND ITS INFLUENCE ON THE AUSTRIAN PRIVATE EQUITY MARKET.", 88 pages, bound, and that I have not used any source or tool other than those referenced or any other illicit aid or tool, and
2. that I have not prior to this date submitted this Master's Thesis as an examination paper in any form in Austria or abroad.

Vienna, 31. August 2010

Signature

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Executive Summary

Private Equity Industry (PE) has become a significant player in the world of mergers & Acquisitions. Trillions of Euros has flown into these funds from investors both Institutional as well as High net worth individuals from all corners of the world. In a study by Morgan Stanley in 2007 it was estimated that twentysevenhundred PE funds accounted for 25 percent of global M&A and soaked up 50 percent of the total leverage loan volume, 33 percent of the high –yield bond market and 33 percent of all Initial Public offerings (IPOs).

In a study of more than 2000 PE transactions Paul Rogers and Dan Hass of Bain Capital discovered that the secret to most successful performers in private equity does not lie in any fundamental structural advantage they hold over other companies (public) rather it lies in the rigour of managerial discipline that they exert on their businesses.

Private equity is an industry that is still heavily concentrated in two economies, the US and the United Kingdom. All top ten Equity players measured by asset under management are American. Europe is responsible for almost all the worlds remaining private equity transactions, and half of the European funds are under management in the UK. Of the total funds raised in Europe in 2008, UK accounted for € 46 billion or 58 percentage of total funds raised[1] . The shear size and wealth of the world richest and fifth largest respectively play their part. But seize is not everything. Private equity activity in Germany, the worlds third-largest economy, was worth just € 2.2 billion far behind UK and under half of Sweden. Since 2003 and to date the 50 largest private equity firms in the world have raised an aggregate of USD 800 billion in private equity direct investment capital.

While private equity firms try to increase value of the company over time, buy-out deals are designed to make quick profits through management fees and financial engineering as well. Private equity is constantly under fire from all corners of the public for looking too much on short - term profit rather that improve the viability of the acquired companies over time.

There are three major questions/trends that surrounds the industry at the moment.

- The consequence of heavy leveraging on future defaults
- Transparency and regulation

- And Taxation of the private equity industry

The Austrian capital market continues to differ in many aspects from structures common in other developed economies. Quoted and unquoted equity are heavily under-represented among the sources of capital used by Austrian enterprises. For example in the EU as a whole quoted equities account for around 18% of aggregate corporate liabilities. In contrast in Austria they account for around 6% of corporate liabilities, indicating the distance Austria still has to travel to fully develop an equity culture, despite the progress made in recent years.

The share of loans as a source of capital has declined in Austria in recent years from an unusually high level. Greece, Spain, Denmark, Italy and Portugal now all have a greater share to total non-financial corporate liabilities in the form of loans and only France, of the major EU economies, has a markedly lower reliance on this source of capital.

Though long-term loans are of diminishing relative importance for the business sector in Austria, the data suggest that banks and foreign lenders are increasing their relative importance as sources of long-term lending, while the role of the government, insurance companies and pension funds is diminishing (probably as they are now in investing in corporate bonds in line with the development of this market in Austria). The post-crisis banking environment may lead to greater difficulty in securing or retaining funding from the banks.

Austria possesses a larger corporate bond market relative to the size of its economy than the EU average. In 2008 only Greece and the UK had heavier weightings to this form of capital.

Austria has fewer businesses relative to its population than the average for the EU. While Small and Medium Sized Enterprises (SMEs) constitute the same proportion of total businesses as across the EU, overall there are only around 33 businesses in Austria for every 1,000 inhabitants, compared with 40 for the EU as a whole. Within the SME sector

Austria possesses a disproportionately large share of small and medium sized enterprises, but a smaller share of micro enterprises.

According to the European Commissions scoring of attributes of the SME business environment Austria achieves a ranking in line with the EU average. However, the indicators that underpin this ranking show areas of particular strength and weakness. Austria scores poorly for the availability of venture capital at both early stage and expansion stages of business development; for the availability of guarantees covering finance for start-ups and SMEs; and for the strength of legal rights. In the World Bank "Doing Business" tables Austria stands 132nd out of 183 countries for investor protection – a measure that includes disclosure standards, director liability and the ease with which shareholders can pursue lawsuits. Investor protection is also an issue that has been highlighted by Austria's central bank.

Private equity investments in Austria were equivalent to only 0.1% of GDP in 2008. This ranks Austria last among European countries. By contrast, the top ranked economies, the UK and Sweden, enjoy ratios around seven times greater than that for Austria; and, only Ireland and Greece, along with Austria, recorded ratios below 0.15% in 2009. This weakness in the use of private equity is a persistent feature of the Austrian capital market over the last decade. While the growth in this form of financing has matched the European average since the mid-1990s, arguably, increasing European integration could have been expected to drive a catch up process for private equity as a source of capital in Austria. This has evidently not happened.

Therefore, there remains considerable scope for the development of aspects of the capital market the type of financing used that will allow Austria to reap the full benefits of increasing European integration. One aspect of this is the development of an environment in which private equity can play a bigger role in financing start-ups, growth businesses and turnaround situations. This aim is a priority for Europe as a whole. For example, ECB research "suggests that the development of significant private equity and venture capital markets would help to overcome difficulties in financing start-ups and other small innovative firms, which in turn would have beneficial effects on growth and productivity."

1. Introduction and Hypothesis development

Private Equity (PE) has become significant player in the world of mergers & Acquisitions. Trillions of Euros has flown into these funds from investors both Institutional as well as High net worth individuals from all corners of the world. In a study by Morgan Stanley in 2007 it was estimated that 2700 PE finds accounted for 25 percent of global M&A and soaked up 50 percent of the total leverage loan volume, 33 percent of the high –yield bond market and 33 percent of all Initial Public offerings (IPOs)

The development of PE took its beginning in the US and spread across the continent to Europe and Asia. The first European region to embrace PE was not surprisingly Great Britain with London as its financial powerhouse, orchestrating the European development. Scandinavia followed soon and only later did Germany and France experience any significant activity in this new venture. Austria contrary to this development barely got started, and today private equity remains a fragment of its European peers. The question is why it is so?

The thesis put spotlight on the global equity industry, its history, players, and performance and resent trends. I then follow up with an in-depth analysis of the Austrian capital market with the aim to answer two fundamental hypotheses:

1. The Austrian capital market differs from structure common to other developed economies and this has influenced the development of an equity culture in general and particular among the Smaller Medium Seize Enterprises (SME) impacting the demand side of Private equity.

2. Private equity (PE) as industry and asset class is suffering from the overall development in the Austrian capital market on both the supply and demand side.

Private equity as asset class is a global industry with global and regional players that has come to influence mergers & acquisitions dramatically within the last one and half decade. There is no doubt that this will continue as evidence in this thesis suggest. It is therefore interesting to understand the basics of private equity, its structure and players.

The thesis begins with a description of the private equity Industry structure and moves on to the analyses of the Austrian capital market and its evolution since the mid-1990s. This description is set in the context of capital market structures elsewhere in Europe and focuses on the supply of capital to non-financial businesses. The following section provides an analysis of the characteristics of the SME sector in Austria – including sources of capital - and compares this with the SME sector in the major European economies.

The function of the capital market is to provide the market infrastructure and institutions that allow supply and demand for capital to be matched. In its widest sense the capital market includes the demands for capital from government and its agencies, households, financial companies and non-financial companies of all sizes. The supply of capital is channelled through a wide range of institutions, including government, banks, pension funds, insurance companies, investment funds and private equity / venture capital specialists. A strong capital market is likely to be made up of a broad mix of institutions supplying capital with different characteristics in terms of, for example, desired type of return, attitudes to risk, term of investment and relationship between the investor and the recipient.

The Austrian capital market continues to differ in many aspects from structures common in other developed economies. For example, both quoted equity and non-bank private equity are heavily under-represented in the capital structure of Austrian enterprises. Hence the Austrian business sector is more reliant on other sources of capital that may be less suited to investments with long payback profiles, but where there are potentially strong long-term returns to the company and the economy. Moreover, the industry knowledge built up by specialist institutional, private equity and venture capital investors may be a crucial element in the availability of suitable financial packages to support growth. The thesis conclude with examines of the minor role that private equity currently plays in the Austrian capital and ends with some more general considerations and the identification of issues for future research and discussion.

2.0 Private Equity

Definition

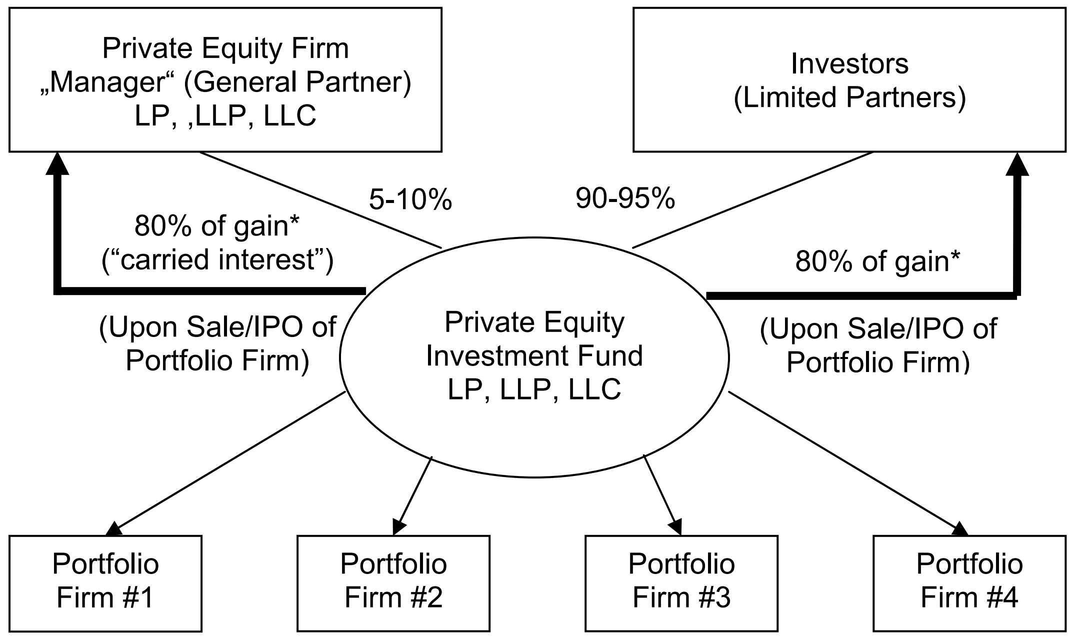
Owning equity in a private company let to the obvious and simple term “Private equity”. Private equity provides equity capital to enterprises not listed on the stock market. Private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company’s balance sheet. It can also resolve ownership and management issues. A succession in family owned companies, or the buy-out and buy-in of a business by experienced managers may be achieved using private equity funding. Some commentators use the term “private equity” to refer only to the buy-out and buy-in investment sector. Others in Europe but not the USA, use the term “venture capital” to cover all stages, i.e. synonymous with “private equity” In the USA “venture capital” refers only to investment in early stage and expanding companies. To avoid confusion, the term “Private equity” is used through this thesis to describe the industry as a whole, encompassing both venture capital (the seed money) and management buy-outs/in

2.1 The Private Equity Industry

Private equity firms have received much attention in recent years due to their substantial impact on merger and acquisition activity and their generous tax treatment in the US and other countries. Private equity firms invest in companies at various stages of their development ranging from their very beginning to their very late stage. Early stage financing of a business is often conducted by so called “angel investors” usually individuals, whereas venture capital is put into firms during take-off, but most private equity investments is concentrated on companies during later stages of growth, and so called special situations/distressed asset.[2] Private equity, see chart 1, is typically organised as limited partnerships (LP´s), which is managed by fund managers typically referred to as General Partners (GP´s) that manage the money raised from LP´s in a legal entity set up for the purpose. This legal entity can have various legal constructions, but is often referred to as a special purpose vehicle (SPV) This SPV is often legally registered in locations which offers attractive tax incentives.

[2] Distressed refers to shares in companies that are in financial trouble or close to bankruptcy. Some funds specialise in this type of situations and buy up shares at discount prices and hope to restructure the company for later profit sale.

Chart 1: Diagram of Typical Organizational Structure for a Private Equity Firm with One PE Fund and Four PE Portfolio Firms



*Approx. ten percent of the total gain is usually to the management team as part of performance based compensation, reducing the investors' share to approx. seventy percent (Fruhan 2009)

Source: London Business School; WP 10-004: "The Impact of Private Equity Ownership…"; Badertscher, Katz, Rego

The most common form of transactions in share deals over the past decade, at least for bigger deals was so called Leveraged Buy Outs (LBO´s) These transactions often involve substantial amount of debt, which is pushed down into the individual portfolio company, often resulting in highly leveraged portfolio firms. PE funds have limited life spans (approximately 10 years) and typically receive a 20 percent share (i.e. "carried interest") of any gains generated by the sale or IPO of their portfolio firms, in addition to annual management fee[3] While the management fees are taxed as ordinary income e.g. 35% in the USA, the carried interest rate in the US is taxed as long term capital gain currently 15%. This tax treatment of carried interest varies across the world.

The tax treatment of carried interest, as well as the fact that some PE firms have been able to avoid corporate taxation once they went public (IPO) has created lot of public debates. One prominent example was the Blackstone Group that provoked enormous

[3] Kaplan and Stromberg 2009. Leveraged buyouts and private equity. Journal of economic perspectives 23 (1): 121-146

negative press worldwide when they went public in 2007 and even led to debates about federal changes to the income tax laws in the US,

The generally negative view of the tax benefits enjoyed by the PE firms contrasts other characteristics associated with their management of portfolio firms. PE firms typically take a controlling stake in their portfolio firms with the intent of substantially improving the performance of their investment. Various researches suggest that PE firms acts as effective monitors of their portfolio firms. This effective monitoring combined with PE firm's financial governance, and operational strategies, as well as concern as to reputation, have a positive impact on their portfolio firms long-term financial performance, as well as financial reporting quality[4].

In a study of more than 2000 PE transactions Paul Rogers and Dan Hass of Bain Capital[5] discovered that the secret to most successful performers in private equity does not lie in any fundamental structural advantage they hold over other companies (public) rather it lies in the rigour of managerial discipline that they exert on their businesses. Their study found that despite the wide spread assumption that the management of a stock listed company is forced by the stock market to concentrate on increasing value of their company, many managers of public companies lack a clear focus on maximising economic returns. Their attention is divided between immediate quarterly financial targets and vaguely long term mission and strategy statements, and they are forced to juggle a variety of goals and targets while coping with stakeholders and other bureaucratic distractions. The opposite seems to be a key component of the secret formula of value creation in private equity, where partners and managers are focusing all their energy on accelerating the growth of the value of the business through relentless pursuit of just one or two key strategic initiatives. Managers are so to say forced to narrow their sight to widen their profits.

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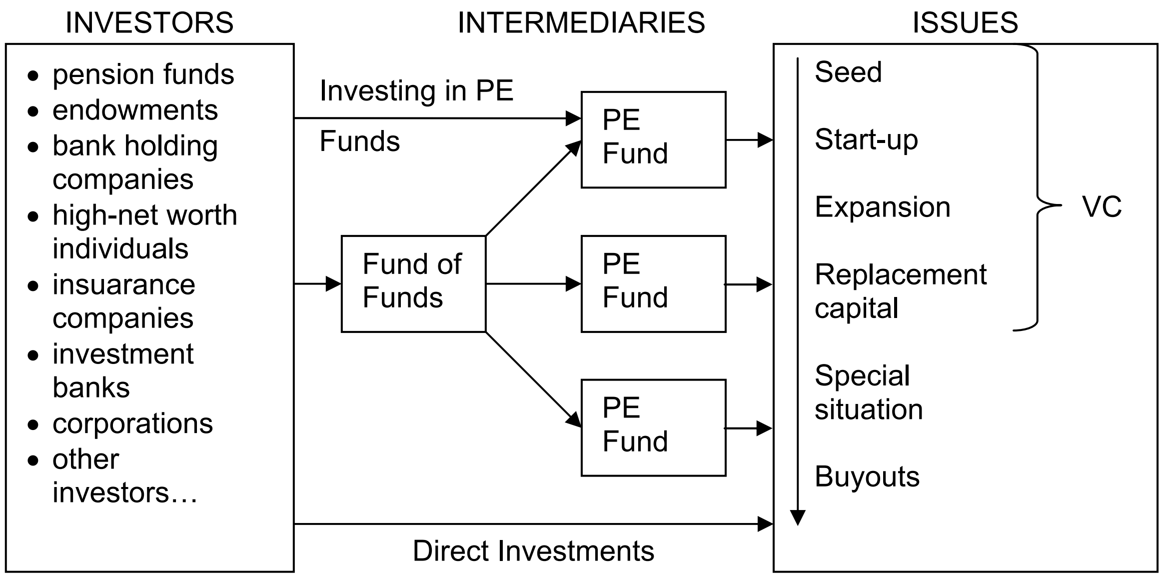
[4] Acharya et al. 2009,; Cao and lerner 2009, Kaplan and Stromberg 2009
[5] lessons from private equity masters publish in Harvard business review 2002

Chart 2: The Private equity Fundraising



Source: Own chart.

As illustrated in chart two, PE firms raise money from a variety of outside investors including investment banks, financial institutions, pension funds, university endowments and wealthy individuals. Since private equity funds are generally less regulated by national authorities than other funds such as mutual funds or pension funds[6] it is considered potential risky, and therefore appeal only to professional investors or wealthy individuals with high-risk profile. In the US for instance, most private equity funds require potential investors to have minimum USD 1 million of net worth and annual income of above USD 200.000. In Europe this varies across Countries. In Austria some PE firms accept smaller investments ranging from €100.000 - € 1 million without any specific declaration of wealth.

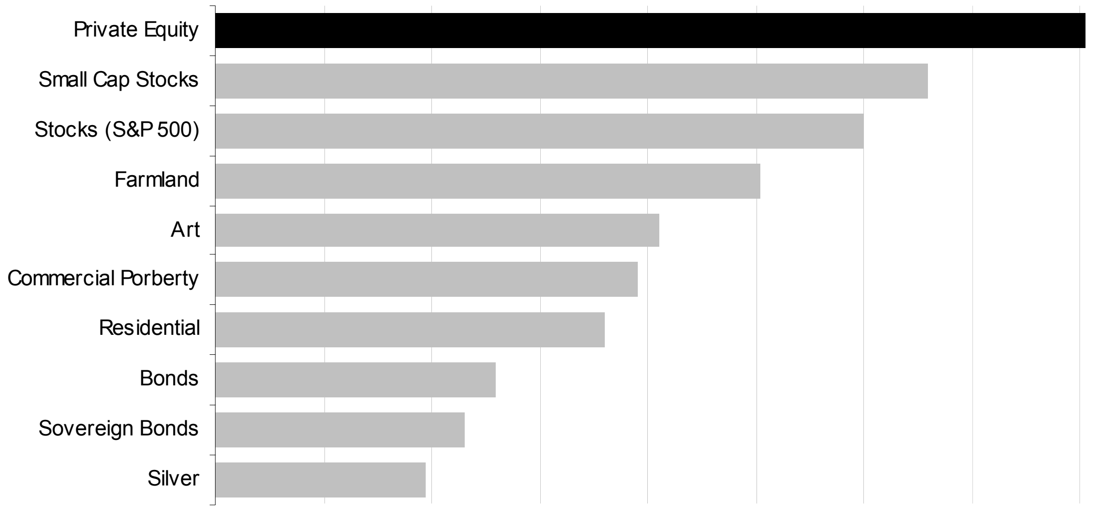
The involvement of pension funds, university endowments (for instance Harvard University) and sovereign wealth funds in private equity business has meant in fact a significant amount of money has flown into private equity funds globally. According to latest statistics[7] private equity has USD 2.5 trillion assets under management and

[6] Mutual fund is a pool of money from several investors that has a predetermined investment objective

[7] Professor Eli Talmor London Business School Collor Institute presentation march 201

committed capital. The 20 largest public US pension funds have USD 111 billion in PE on behalf of 10.5 million beneficiaries, and it is expected to keep growing. Yet these outside investors do not participate in the funds investment decisions. All these investors have turned to private equity and away from shares and government bonds in the hope of getting higher returns on their money. As shown below in the chart historic return on private equity has been the highest compared to other traditional asset classes.

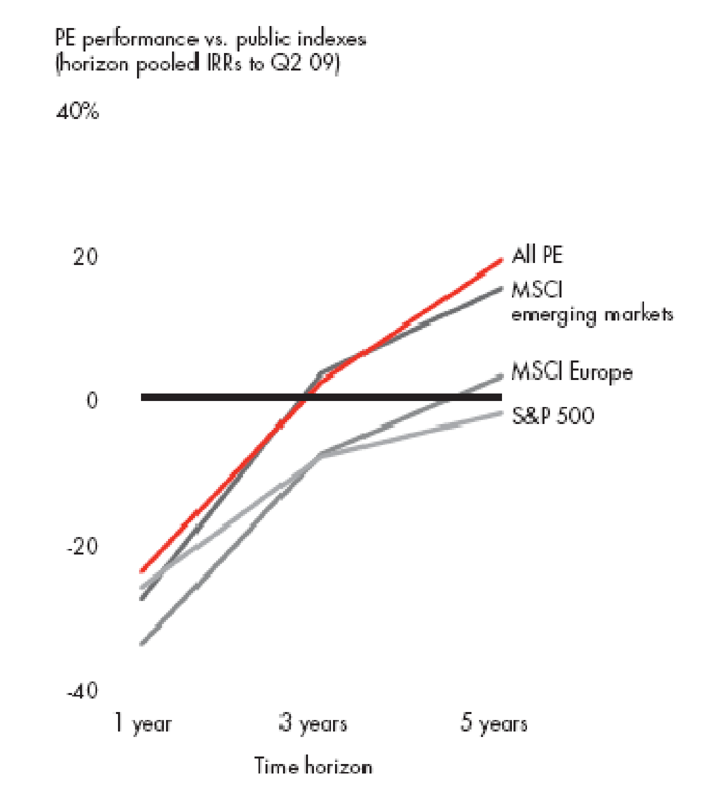
Chart 3: Historic (50y) return on different asset classes



Source: Morgan Stanley 2008

Compared with public equities, PE outperformed both emerging markets, S&P 500 and Europe consistently the last five years as shown in chart 4 below.

Chart 4: PE Compared with public



Source: LBS ; handout PE an overview by Professor Talmor, March 2010

UK private equity return has consistently been above double-digit returns since 1999 and on a 10-year time span significantly outperformed FTSE 100

Charts 5: BVCA PWC Summary Results May 2009

Source: London Business School; Handout: PE: An Overview; Prof. Talmor; March 2010-04-1

As evidenced above, however potentially flawed the numbers might be, there is enough evidence to suggest that private equity as asset class has given investors a possibility to diversify their investment into a new world of potential significant financial returns.

Average life span of a PE fund is typically 8-10 years. The PE fund undertake several investments in target companies; usually no single investment exceeds 20 percent of the total amount of money committed[8] Once investors have placed money with the fund, the money remains locked up for the duration of the fund's life. Unlike investors in public listed companies, that can sell their shares at any moment, passive investors in private equity funds cannot gain access to their money until the private equity firm sells or exit from the companies in their portfolio. This is the potential down seize of this asset class, and one of many reasons why this type of investment should generate higher than average returns for the investor.

In the last decade various "fund of funds" in PE have emerged. These funds allow managers to invest in several private equity funds and give the fund manager the opportunity to diversify his risk in his investment portfolio.

While fund of funds are relative new it is estimated to account for up to 20 percent[9]
Of private equity funds Globally and growing.

2.2 The Players in Private Equity

Private equity is an industry that is still heavily concentrated in two economies, the US and the United Kingdom as shown in the chart 6 below

[8] Quote: Morgan Stanley global private equity, London office Michael Hein Managing director
[9] professor Eli Talmor, LBS – private equity study lecture March 2010

Chart 6: Top 20 Private Equity Firms (as of April 2007)

Private Equity Firm	Assets Under Management ($ billion)	Portfolio Company Employees
The Blackstone Group	79	350,000
The Carlyle Group	56	200,000
Bain Capital	40	662,000
Texas Pacific Group (TPG)	30	300,000
KKR	27	540,000
Cerberus	22	363,000
Providence Equity Partners	21	86,000
Thomas H. Lee Partners	20	391,000
Welsh, Carson Anderson & Stowe	16	62,000
Hellman & Friedman	16	73,000
Warburg Pincus 1	5	375,000
Madison Dearborn	14	149,000
Apollo Management	13	297,000
TA Associates	10	28,000
CCMP Capital Advisors	10	379,000
Goldman Sachs Capital Partners	9	1,050,000
DLJ Merchant Banking Partners	7	63,000
Vestar	7	53,000
Silver Lake Partners	6	301,000
Clayton Dublier & Rice	5	109,000
Onex	5	167,000

Source: Service Employees International Union
Behind the Buyouts: Inside the World of Private Equity
April 2007 p.20.
http://www.behindthebuyouts.org

All top ten Equity players measured by asset under management are American. Europe is responsible for almost all the worlds remaining private equity transactions, and half of the European funds are under management in the UK. Of the total funds raised in Europe in 2008, UK accounted for € 46 billion or 58 percentage of total funds raised[10] the shear seize and wealth of the world richest and fifth largest respectively play their part. But seize is not everything. Private equity activity in Germany, the worlds third-largest economy, was worth just € 2.2 billion far behind UK and under half of Sweden.

Since 2003 and to date the 50 largest private equity firms in the world have raised an aggregate of USD 800 billion in private equity direct investment capital.

[10] See appendix A

Who are the private equity firms? The five largest are The Blackstone Group, The Carlyle Group, Bain Capital, TPG Capital and Kohlberg Kravis Roberts & Co (KKR) Combined those firms manage assets in the 100´s of billions and directly or indirectly control the lives of more than two million employees.

The Blackstone Group, located New York –
Asset under management USD 49.7 billion

PE leader The Blackstone Group grabbed headlines in 2007 by launching an IPO of its management company, a move that raised $4 billion for the firm and hundreds of millions for its founders. Peter Peterson, the former chairman of Bell & Howell and Lehman Brothers, founded the firm in 1985 with Lehman Brothers mergers-and-acquisitions chief Stephen Schwartzman. The firm started with four people and $400,000 in assets. Today, Schwartzman alone has an estimated personal net worth of $3.5 billion. Blackstone earned a reputation for working with willing targets in the '80s, when hostile takeovers were common. It also made a practice of putting a significant amount of its own capital at risk in each of its transactions.

The Carlyle Group, located Washington D.C –
Assets under management USD 39.8 billion

The Washington-based buyout firm, is run by former IBM chief Louis Gerstner Jr. and loaded with former government officials, including former Securities & Exchange Commission chairman Arthur Levitt, President Clinton's former chief of staff Mack McLarty, and former Federal Communications Commission chairman Bill Kennard. Former President George H.W. Bush was at the firm, but he retired in 2003. Relatives of Osama bin Laden have been investors in the firm. But Carlyle ended those ties after September 11, even though the family members decried the attack. The company led **a** $15 billion buyout of car rental agency Hertz several years ago. It went public again in late 2006, selling 28% of its shares to the public. Carlyle also participated in 2006's $11 billion buyout of Dutch media concern VNU, which owns the Nielsen media ratings service.

Kohlberg Kravis Roberts, located in New York –
Asset under management USD 32.9 billion

KKR defined the wheeling and dealing of the late '80s with its record $31.4 billion takeover of RJR Nabisco. Founded in the 1970s by Bear Stearns alumni Jerome Kohlberg, Henry Kravis, and George Roberts, the firm was known for hostile takeovers. It used junk bonds raised by Drexel Burnham, led by Michael Milken who was later imprisoned. KKR has continued its global expansion. It is following Blackstone down the path towards an initial public offering. It has also launched a flurry of deals, including the $27.7 billion buyout of First Data, the $20.5 billion acquisition of British retailer Alliance Boots and the $43.8 billion purchase of an energy company. It used its latest $14.8 billion fund to invest $700 million in Sun Microsystems. And KKR and Texas Pacific have recently weighed a $100 billion takeover of Home Depot, according to *The New York Post*. KKR is in the process of raising $16.6 billion for its next fund.

Texas Pacific Group, Located Forth Worth Texas –
Asset under Management USD 31 billion

Founded in 1992 by David Bonderman and others, the firm had a hit with its 1992 Burger King buyout. Bonderman, has taken stakes in companies from Ducati motorcycles to retailer J. Crew. He hired The Rolling Stones to play at his 60th birthday party in 2002 in Las Vegas. In 2007, TPG co-led the $27.9 billion buyout of wireless phone company Alltel and played a leading role in the $43.8 billion buyout of energy company TXU. TPG and Sony bought out MGM films in 2005. In 2006, TPG and Apollo won a $17 billion deal for Harrah’s Entertainment. It participated in 2006's $17.6 billion buyout of Freescale Semiconductor and a $10.9 billion buyout of health-care company Biomet.

Permira, located London –
Asset under management USD 26.2 billion

A collection of 18 separate funds, European private equity player Permira has invested in a wide range of companies, from HMV record stores to the Intelsat satellite operation. The firm, led by managing partner Damon Buffini, invests in chemicals, entertainment, media and technology, industrial products, and consumer goods. Permira participated in the $17.6 billion Freescale buyout in 2006. Other bigger investments includes personal protection company Aereo Technologies and TV production unit All3media.

Bain Capital Partners, Located Boston US –
Asset under management USD 21 billion

Mitt Romney, who went on to become governor of Massachusetts, and briefly considered running for president for the republicans in 2008, founded Bain in 1984. Bain Capital was spun off from Bain Consulting. It got off to a fast start by investing in the office supply store Staples. One of the latest big deals was Bain taking part of a group that took control of the semiconductor unit at Philips known as NXP. Bain also teamed with Thomas Lee to offer $19 billion for Clear Channel Communications. In 2006, Bain worked with KKR, Blackstone, and others in the $33 billion buyout of the HCA hospital company.[11]

Apax Partners, Located London –
Asset under management USD 19.2 billion

Co-founder Alan Patricof got in early on Apple Computer and AOL. The firm now operates in Europe, the U.S., and Israel and invests in a wide range of businesses, from clothing designer Tommy Hilfiger to food company Grupo Panrico of Spain. In addition to his work as an investor, Patricof has been a major fund-raiser for the Democrat party in the US. In 2006, Apax and others took control of TDC, the Danish tech and Telecom Company, for more than $11.5 billion.

In 2007, their most recent peak year the top 50 private equity firms raised more than XX billion in direct investment capital giving the industry tremendous firepower to continue privatising companies once listed on the public stock exchange. The financial crises of late has no doubt put a hold to the buyout boom, but few doubt that this is lasting, and in

[11] source: http://images.businessweek.com/ss/07/01/0131_private_equity/source/12.htm -

the future we will see more privatisations from giant retailers to utilities, airlines etc. following in the foot steps of such renowned brands like Toys “R” Us, Burger king, Polaroid, Boots, Jimmy Choo and Dunkin Donuts to mention a few.

Private equity’s importance is further magnified by its link to sovereign Wealth funds (SWF) these funds are state owned financial conglomerates comprising mutual asset classes such as stocks, property, bonds and private equity.

One very well know fund is Temasek Holdings, a sovereign wealth fund owned solely by the government of Singapore, and operates very actively as a private equity firm. Another is the china Investment Corporation, another SWF that bought a USD 3 bln. Stake in Blackstone when they went public in 2007. The Abu Dhabi’s government via Mubadala, its SWF, was also following the trend and bought a 7.5 percent stake in The Carlyle Group for USD 1.5 billion

Hedge funds are also very active in the industry of private equity. It is hard to get exact estimates of their direct influence or funding, but PE, SWF and hedge funds combined are managing trillion of dollars worth of assets and liquidity in the global market.

Private equity and hedge funds are often perceived as identical investment vehicles. Both enjoy little regulatory monitoring, base their business model on leverage and provide a very healthy living to their owners. So what exactly is this industry about and how does it function?

2.3 History of Private Equity

The history of private equity and venture capital and the development of these asset classes have occurred through a series of boom and bust cycles since the middle of the 20th century. Within the broader private equity industry, two distinct sub-industries, leveraged buyouts and venture capital experienced growth along parallel, although inter-related tracks.

Since the origins of the modern private equity industry in 1946, there have been four major epochs marked by three boom and bust cycles. The early history of private equity from 1946 through 1981—was characterized by relatively small volumes of private equity investment, rudimentary firm organizations and limited awareness of and familiarity with the private equity industry. The first boom and bust cycle, from 1982 through 1993, was characterized by the dramatic increase in leveraged buyout activity financed by junk bonds and culminating in the massive buyout of RJR Nabisco before the near collapse of the leveraged buyout industry in the late 1980s and early 1990s. The second boom and bust cycle (from 1992 through 2002) emerged out of the ashes of the savings and loan crisis, the insider trading scandals, the real estate market collapse and the recession of the early 1990s. This period saw the emergence of more institutionalized private equity firms, ultimately culminating in the massive Dot-com bubble in 1999 and 2000. The third boom and bust cycle (from 2003 through 2007) came in the wake of the collapse of the Dot-com bubble—leveraged buyouts reach unparalleled size and the institutionalization of private equity firms is exemplified by the Blackstone Group's 2007 initial public offering.

In its early years through roughly the year 2000, the history of the private equity and venture capital asset classes is best described through a narrative of developments in the United States as private equity in Europe consistently lagged behind the North American industry. With the second private equity boom in the mid-1990s and liberalization of regulation for institutional investors in Europe, the emergence of a mature European private equity market has occurred.

Investors however have been acquiring businesses and making minority investments in privately held companies since the dawn of the industrial revolution. Merchant bankers in London and Paris financed industrial concerns in the 1850s.

Later, J. Pierpont Morgan's J.P. Morgan & Co. would finance railroads and other industrial companies throughout the United States. In certain respects, J.P. Morgan's 1901 acquisition of Carnegie Steel Company from Andrew Carnegie and Henry Phipps for $480 million represents the first true major buyout as they are thought of today.

Due to structural restrictions imposed on American banks under the Glass-Steagall Act and other regulations in the 1930s, there was no private merchant banking industry in the United States, a situation that was quite exceptional in developed nations. US investment banks were confined primarily to advisory businesses, handling mergers and acquisitions transactions and placements of equity and debt securities. Investment banks would later enter the space, however long after independent firms had become well established.

With few exceptions, private equity in the first half of the 20th century was the domain of wealthy individuals and families. The Vanderbilt's, Whitney's, Rockefellers and Warburg's were notable investors in private companies in the first half of the century. In 1938, Laurance S. Rockefeller helped finance the creation of both Eastern Air Lines and Douglas Aircraft and the Rockefeller family had vast holdings in a variety of companies. Eric M. Warburg founded E.M. Warburg & Co. in 1938, which would ultimately become Warburg Pincus, with investments in both leveraged buyouts and venture capital.

2.4 Origins of modern private equity[12]

It was not until after World War II that what is considered today to be true private equity investments began to emerge marked by the founding of the first two venture capital firms in 1946: American Research and Development Corporation. (ARDC) and J.H. Whitney & Company.

ARDC was founded by Georges Doriot, the "father of venture capitalism" (founder of INSEAD and former dean of Harvard Business School), with Ralph Flanders and Karl Compton (former president of MIT), to encourage private sector investments in businesses run by soldiers who were returning from World War II. ARDC's significance was primarily that it was the first institutional private equity investment firm that raised capital from sources other than wealthy families. Former employees of ARDC went on to found several prominent venture capital firms. ARDC continued investing until 1971 where it finally closed down after having invested in over 150 companies.

J.H. Whitney & Company was founded by John Hay Whitney and his partner Benno Schmidt. Whitney had been investing since the 1930s, founding Pioneer Pictures in 1933 and acquiring a 15% interest in Technicolor Corporation with his cousin Cornelius Vanderbilt Whitney. J.H. Whitney & Company continues to make investments in leveraged buyout transactions and raised $750 million for its sixth institutional private equity fund in 2005.

[12] Internet research – various public information and articles

Before World War II, venture capital investments (originally known as "development capital") were primarily the domain of wealthy individuals and families. One of the first steps toward a professionally managed venture capital industry was the introduction of the Small Business Investment Act of 1958. The 1958 Act officially allowed the U.S. Small Business Administration (SBA) to license private "Small Business Investment Companies" (SBICs) to help the financing and management of the small entrepreneurial businesses in the United States. Passage of the Act addressed concerns raised in a Federal Reserve Board report to Congress that concluded that a major gap existed in the capital markets for long-term funding for growth-oriented small businesses. Additionally, it was thought that fostering entrepreneurial companies would spur technological advances to compete against the Soviet Union. Facilitating the flow of capital through the economy up to the pioneering small concerns in order to stimulate the U.S. economy was and still is the main goal of the SBIC program today. Interesting enough the leading political parties of Austria today (2010) discuss how Austria can potentially stimulate more entrepreneurship and innovation via venture and equity funds. Still this issue has not been solved!

2.5 Early venture capital and the growth of Silicon Valley (1959 – 1981

During the 1960s and 1970s, venture capital firms focused their investment activity primarily on starting and expanding companies. More often than not, these companies were exploiting breakthroughs in electronic, medical or data processing technology. As a result, venture capital came to be almost synonymous with technology finance.

It is commonly noted that the first venture-backed startup was Fairchild Semiconductor (which produced the first commercially practicable integrated circuit), funded in 1959.

It was also in the 1960s that the common form of private equity fund, still in use today, emerged. Private equity firm’s organized limited partnerships to hold investments in which the investment professionals served as general partner and the investors, who were passive limited partners, put up the capital. The compensation structure, still in use today, also emerged with limited partners paying an annual management fee of 1-2% and a carried interest typically representing up to 20% of the profits of the partnership.

The growth of the venture capital industry was fueled by the emergence of the independent investment firm in California, beginning with Kleiner, Perkins, Caufield & Byers and Sequoia Capital in 1972. Located in California, Kleiner Perkins, Sequoia and later venture capital firms would have access to the growing technology industries in the area. Throughout the 1970s, a group of private equity firms, focused primarily on venture capital investments, would be founded that would become the model for later leveraged buyout and venture capital investment firms. In 1973, with the number of new venture capital firms increasing, leading venture capitalists formed the National Venture Capital Association (NVCA). The NVCA was to serve as the industry trade group for the venture capital industry. Venture capital firms suffered a temporary downturn in 1974, when the stock market crashed and investors were naturally wary of this new kind of investment fund. It was not until 1978 that venture capital experienced its first major fundraising year, as the industry raised approximately $750 million. During this period, the number of ventures firms also increased. Among the firms founded in this period, in addition to Kleiner Perkins and Sequoia, that continue to invest actively are TA Associates, Mayfield Fund, Apax Partners, New Enterprise Associates, Oak Investment Partners and Sevin Rosen Funds, all of the prominent international players in today’s industry.

Venture capital played an instrumental role in developing many of the major technology companies of the 1980s. Some of the most notable venture capital investments were made in firms that include: Tandem Computers, Genentech, Apple Inc., Electronic Arts, Compaq, and Federal Express

Although not strictly private equity, and certainly not labeled so at the time, the first leveraged buyout may have been the purchase by Malcolm McLean's McLean Industries, Inc. of Pan-Atlantic Steamship Company in January 1955 and Waterman Steamship Corporation in May 1955. Under the terms of the transactions, McLean borrowed $42 million and raised an additional $7 million through an issue of preferred stock. When the deal closed, $20 million of Waterman cash and assets were used to retire $20 million of the loan debt. The newly elected board of Waterman then voted to pay an immediate dividend of $25 million to McLean Industries.

Similar to the approach employed in the McLean transaction, the use of publicly traded holding companies as investment vehicles to acquire portfolios of investments in corporate assets would become a new trend in the 1960s popularized by the likes of

Warren Buffett. These investment vehicles would utilize a number of the same tactics and target the same type of companies as more traditional leveraged buyouts and in many ways could be considered a forerunner of the later private equity firms.

Warren Buffett, who is typically described as a stock market investor rather than a private equity investor, employed many of the same techniques used in private equity (LBO) in the creation on his Berkshire Hathaway conglomerate. In 1965, with the support of the company's board of directors, Buffett assumed control of Berkshire Hathaway. At the time of Buffett's investment, Berkshire Hathaway was a textile company, however, Buffett used Berkshire Hathaway as an investment vehicle to make acquisitions and minority investments in dozens of the insurance and reinsurance industries, and varied companies including: American Express, The Buffalo News, the Coca-Cola Company. Buffett's value investing approach and focus on earnings and cash flows are characteristic of later private equity investors. Buffett would distinguish himself relative to more traditional leveraged buyout practitioners through his reluctance to use leverage and hostile techniques in his investments

2.6 The Fee structure

Look for a man in a 1500€ suit and a Rolex watch and you find an Investment banker or a private equity manager. But before he can buy his designer clothes and exit any deals he first has to earn the money and find the deals.

Private equity firms are set up differently depending on the legal, regulatory and tax regimes in which they operate. Typically the firms operate through a combination of onshore and offshore partnerships, investment trusts and Special Purposes Vehicles (SPV)[13] see also chart 1 for reference.

The private equity industry is generating its income quite differently from lets say an investment banker investing in stocks, bonds or other public traded asset classes. The investment banker will rely on the development in the stock or the bond to generate a profit. In private equity the rule is usually 2:20 principle. Most often the general Partner

[13] SPV is a legal entity, such as a limited company or partnership, created for the sole purpose of acquiring and holding an asset for the sole benefit of the investor in the SPV

(GP) are compensated with annual management fees of 2 percent of the committed capital. 5 billion funds will generate 100 million in annual management fees for the general partner of the private equity fund. In addition the GP normally gets a "carried interest" which is a performance fee paid to managers based on the profit generated by the fund. Typically the general partner gets a carried interest of 20 percent of the profits. Often gross private equity returns are in excess of 20 percent per year, particularly in the case of leveraged buyout firms. The 2:20 principle has remained intact despite the huge amount of money under management. However this somewhat perverse incentive for general partners to create huge funds are under lots of public critics, and the trend in the industry will likely lead to a revision of the whole incentive system, with management fees coming under pressure.

The invention "carried interest" for performance fees has considerable tax benefits especially in the US and UK. Both countries treat this carried interest as investment income rather than earned income. In the US carried interest is taxed as capital gains with 15 percent rather than 35 percent income tax rate. However in the UK, similar tax concessions allow private equity firms to pay as little as 10 percent taxes, compared with the country's 40 percent top rate income tax. Not surprisingly this tax benefit is heavily criticized by all sectors of public life and seen as a tax loophole that should be stopped. In the US this tax concession is at least in place until end of 2010.

Nicolas Ferguson chairman of SVG capital, put fire to the public outcry when he back in 2007 noted that private equity partners "pay less tax than a cleaning lady"[14]

2.7 Get wealthy as GP in Private equity

Many private equity tycoons can thank these special tax treatments for their fantastic wealth. Schwartzman of Blackstone is one good example. When he took his firm public in 2007 he received $677.2 million in cash from the public offering and his remaining shares was worth an estimated $7.8 billion, making him one of the richest men in the country.[15]

But he is not alone, according to US business magazine Forbes, the top 20 managers of

[14] http://ftalphaville.ft.com/blog/2007/06/04/4937/svg-chairman-breaks-tax-taboo/ Financial times 3 june 2007

[15] http://www.newyorker.com/reporting/2008/02/11/080211fa_fact_stewart

private equity and hedge funds on Wall Street earned an average of USD 657 million in 2006[16] One could suspect that these PE and hedge fund managers lost out during the financial crises starting 2008. But according to AR: Absolute Return + Alpha magazine A ranking of U.S. hedge fund managers revealed earnings broke a record in 2009 with the manager at the top of the list, David Tepper, earning $4 billion. Tepper, who manages $12 billion in investments at Appaloosa Management, said he bet that the U.S. government would not permit the nation's largest banks to collapse, investing in financial firms when they were down and other investors were running for the exits.

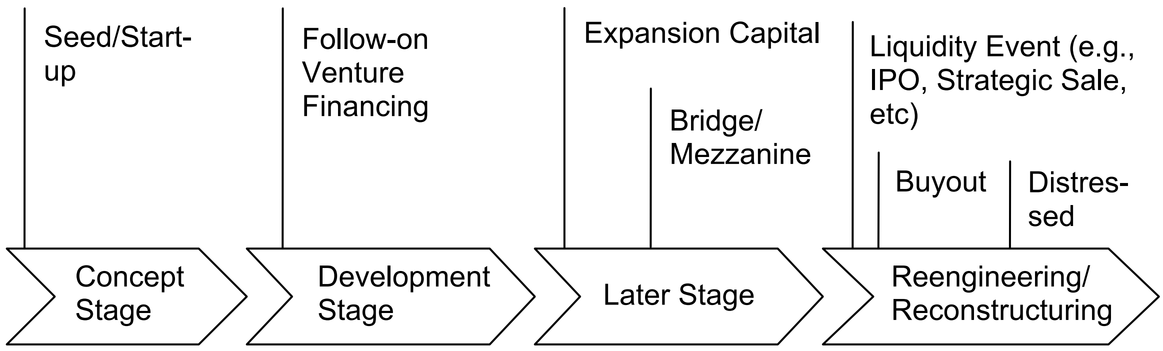
"We bet on the country's revival," he said in a New York Times report[17] another familiar name in the industry George Soros earned $3.3 billion, coming in second.

[16] http://www.forbes.com/2007/05/03/ceo-executive-compensation-lead-07ceo-cx_sd_0503ceocompensationintro.html
[17] http://www.commodityonline.com/news/US-hedge-fund-earnings-broke-records-in-2009-27090-3-1.html

3.0 The Private equity Business Model

Private equity invest at all stages of the corporate life cycle as demonstrated in chart 7 below

Chart 7: Private Equity Invests at All Stages of the Corporate Life Cycle

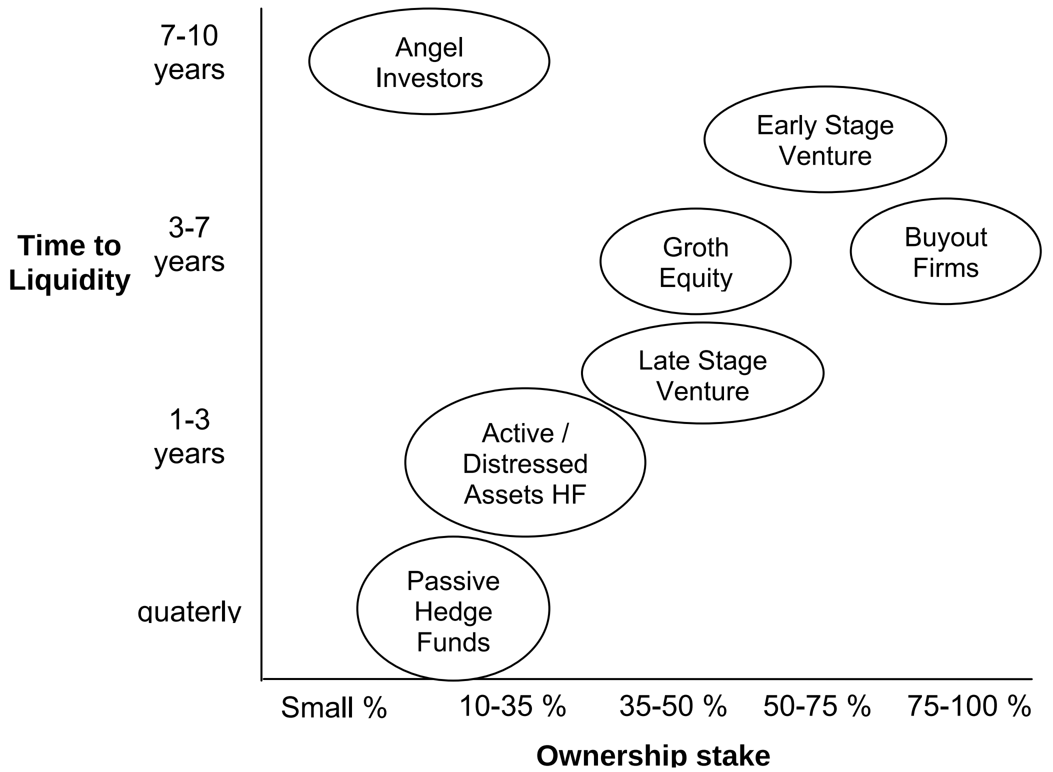


Source: own chart

Private equity can be an active investor from concept stage of a business idea to very late mature stage and even in case of a need of restructuring to avoid bankruptcy. A private equity fund will typically formulate a funds strategy, which clearly outlines its strategic focus such as industries and geography in which to invest. Some funds will invest only in start-up with majority shares. Other funds specialize in distressed assets and go for turnarounds.

As investor you can find many different fund profiles. Chart 8 below is trying to illustrate what would be the expected industry ownership structure and holding period (exit) for various investment vehicles. As an angel investor you would typically expect to be invested for 7-10 years and have only a minority share. As angel investor you are basically only funding the start up or even the execution of a business idea. The situation is somewhat different in a buy-out fund. Expected holding period of the acquired company (or fund) is 3-7 years. Buy-out is often a complete takeover of the acquired firm (100% share-ownership) or minimum a majority stake (+50%)

Chart 8: holding and ownership in different funds/vehicles

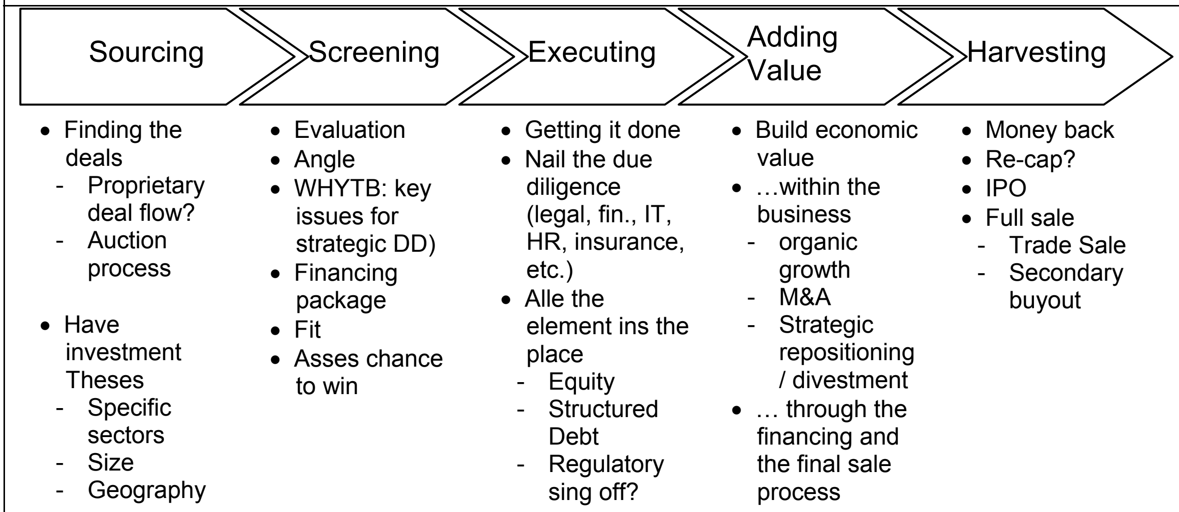


Source: London Business School; Handout: PE: An Overview; Prof. Talmor; March 2010-04-1

3.1 Private Equity Value Chain

Private equity value chain can be divided into five steps as illustrated below:

Chart 9: Private Equity Value 5 step value chain



Source: own illustration

The private equity firm finds its potential deal flow from many sources. Deals can be presented from investment banks, M&A boutiques, and Consulting companies, managers that are thinking of a Management buy Out (MBO) or companies that take direct contact. The competition for deals has increased significantly among the various funds. Very often competition for a deal led to inflated evaluations, where the only justification for the price setting was the financial leverage opportunity. Once the deal has been concluded, the equity owner executes the business plan defined during and after the Due diligence process and the road to increase of value can be manifold. Some funds base their strategy on consolidation of a particular industry, and will then focus on add on acquisitions. Other has specific industry knowledge and will focus their approach on operational performance enhancement. The private equity fund will often well in advance of the planned exit have considered what would be the optimal exit strategy. This could be a listing (re-listing) on the stock exchange (IPO) or a potential trade sale to another player in the industry.

3.2 Leveraged Buy-outs (LBO)

Nearly 74 percent of investments in 2008 in Europe were in buyouts[18], with 13 percent in venture and 13 percent in growth capital (injecting money in existing portfolio companies).

Since most funds are allocated towards buyout funds I will focus only on this type of transactions. Private equity practices two distinct types of buyouts:

- Leveraged Buyouts (LBO), in which private equity firms use debt to take control of a business
- Management Buyouts (MBO), in which private equity firms help the existing management of a company to acquire it and gain a stake in the company in return,

3.3 Sources of Buy-outs

There are equally many sources for buy-outs, as for other private equity deals. One source is divestment of large conglomerates of non-core business. This was often seen in the late 1980´s with Austria as no exception. State sector privatization gathered pace during the second half of the 1980s and produced a Sharpe increase in MBOs. The pressure of senior corporate managers to maximize shareholder return in their disposal program meant that in the second half of the 1990s, managers of subsidiaries were no longer seen as preferred bidders especially for larger transactions. The difficulties in completing traditional divestment management buy-outs, were accompanied by the growth of externally generated buy-out acquisitions of subsidiaries, notably the investor led or institutional buy-out (IBO). More recently family firms, and those in private hands, have provided the bulk of buy-outs, reflecting the need for the owners for a successor and/or wealth diversification.

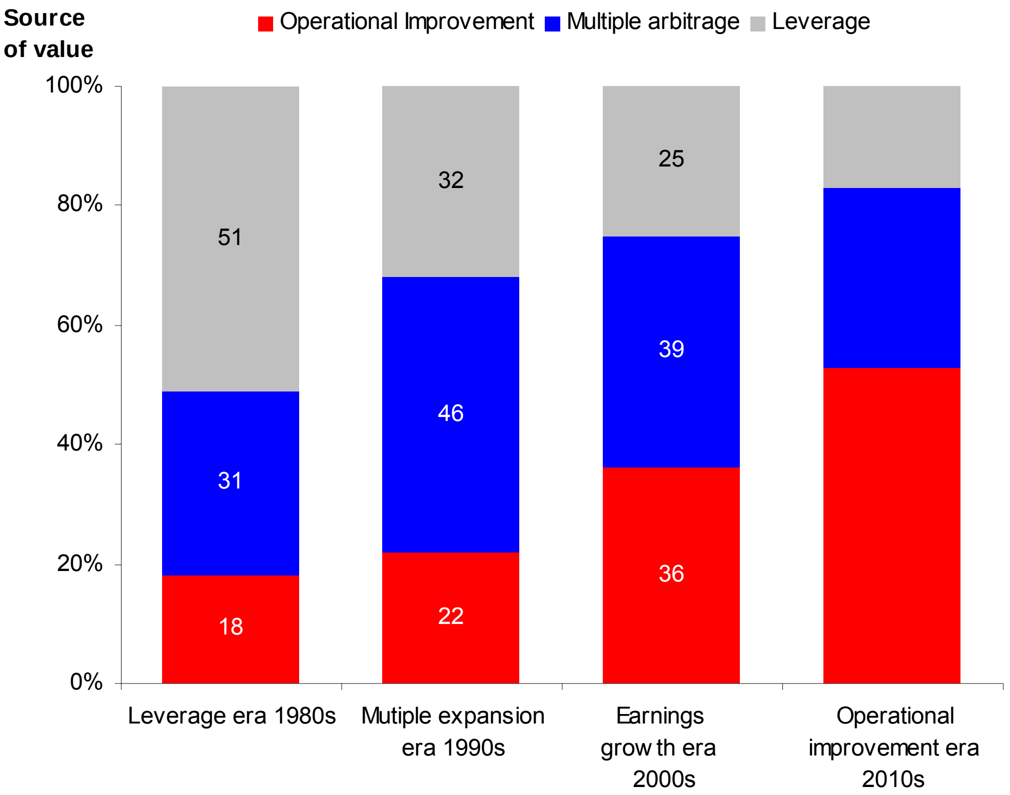
The buy-out process starts by taking a publicly listed company completely private, or at least enough shares of the company to take it off the stock exchange. The philosophy of the private equity is that this move takes away the pressure on the business to meet

[18] 2009 EVCA Yearbook – June 2009

short-term financial targets potentially hampering a long-term value creating strategy. But taking a company private also allows private equity firms to escape the legal requirements of a public listed company, not only financial reporting but also the scrutiny of diverse shareholders, public interest groups and other stakeholders. In private equity managed firms, it is not even disclosed to investors (LP´s) how the portfolio companies operate.

In a LBO private equity firms borrow money to acquire a company or an asset, using cash flow and assets of the acquired company as collateral. The required company records the debt on its own balance sheet and its cash flow is used to repay debt. Leveraged buy-outs enable private equity firms to undertake mega-acquisitions, without having to commit as much capital as they would otherwise have to. Up until the financial crisis a typical LBO comprised up to 80 percent debt and 20 percent equity. It has to be stated that this highly leveraged financing has changed somewhat since the financial crises kicked in beginning of 2008 and it is no longer possible to obtain leverage (credit) to level seen in the hey days (70% and more) latest Industry benchmarks suggest down to 40-50 percent based on the individual deal, industry and risk involved. A resent study by Goldman Sachs and Boston Consulting Group (see chart below) pinpointed the evolution of operational improvement levers over time, from highly leverage buy-out deals in the 80´s to a new age of value creation in present time. It suggests that creating value in the future is going to come from old fashioned basics like sound strategy, competitive advantaged products, operational improvement and skillful management.

Chart 10: Private Equity Source of Value



➔ Leverage halved
➔ Operational improvement doubled

Source: Goldman Sachs & Boston Consulting Group 2008

3.4 Leverage and Value

The basic value creation formula used in LBOs is debt. Debt can actually increase value if engineered cleverly and used in the right type of company. Private equity investor is concerned about his Return on Equity (ROE) the higher the better! The fundamental idea is re-focus the acquired business to lower cost and improve efficiency. But value can also be created through basic finance, which says debt can increase a firm's value. However the question of whether changing the mix of debt and equity can alter value of a business has long been debated in finance. When examining the leverage components of an LBO, it is essential to determine whether changing the mix of debt and equity can change the value of the company.

Debt has two key benefits, relative to equity from a financial perspective. First, the interest paid on debt is tax deductible, whereas cash flow to equity (such as dividends) is generally not. Therefore the higher the tax rate, the greater the tax benefit of using debt. The second benefit of debt is subtler. The use of debt, it can be argued, forced managers to be more disciplined in project selection and how they manage their cash. That is a company funded entirely by equity and strong cash flow has a tendency to become lazy. Because the debt requires the company to pay interest rates investing into too many bad projects can ultimately drive the company into bankruptcy. Relative to equity, the use of debt has three disadvantages[19] - an expected bankruptcy cost, an agency cost, and the loss of future financing flexibility.

- The expected bankruptcy cost has two components. One is simply that as debt increases, so does the possibility of bankruptcy. The other component is the cost of bankruptcy itself, which has more parts. One is the direct cost of going bankrupt; such as legal fees etc. the other element is the effect it has on operations. When customers learn that a company is in financial trouble they start looking elsewhere for suppliers or places to buy their product. The employees get concerned about their future job prospects and start looking for other jobs. This creates a downward negative spiral that ultimately ends in bankruptcy.
- Agency costs arise from different and competing interest of equity investors and lenders in a company. Equity investors see more upside from risky investments than lenders tends to do. So consequently private equity investors let alone will take more risk in investments than lenders would want them to do. Another agency cost is created because lenders assume there might be some game playing or excess risk taking by equity investors, and therefore charge higher interest rates. In this case the borrower bears the agency cost.
- When companies borrow more money up front they might loose the potential to borrow more money in the future. This could lead to a situation where the company is unable to make investments that could make good business sense, because they have lost the flexibility in it’s financing.

[19] Aswath Damodaran, professor of Finance Leonard Stern School of Business, NY in his article the anatomy of an LBO, September 2008, CFA institute

There will always be a trade off between debt/equity. However to assess the right level is of critical importance. Before applying debt, it’s critical to evaluate the future cash flow of the business. Net cash flow is what will be used to pay down debt. If the firm is too highly leveraged (indebted) and cash-flow can’t pay down debt, the business risk insolvency and ultimately bankruptcy as

The private equity industry has made a science out of financial engineering. The reason why private equity loves stable businesses with predictable cash flows is the opportunity to leverage. The basic formula used is Return on Equity (ROE), which is a measure of what you get back for each euro invested in equity in the business.

Chart 11: The Basic Value Creation Formula - Debt can increase Value

Dupont Equation

$$ROE = \frac{NI}{Equity} = \frac{NI}{Sales} X \frac{Sales}{Total\ Assets} X \frac{Total\ Assets}{Equity}$$

Leverage – Debt↑ as % of Assets ➔ Equity↓ ➔ Multiplier↑ ➔ ROE↑

Consider a company that takes on debt at a cost of $3 in Net Income, but changes NOTHING ELSE.

$$\frac{NI}{Sales} X \frac{Sales}{Total\ Assets} X \frac{Total\ Assets}{Equity} = ROE$$

$$\frac{16}{160} \quad X \quad \frac{160}{100} \quad X \quad \frac{100}{100} \quad = \frac{16}{100} = 16\%$$

$$\frac{12}{160} \quad X \quad \frac{160}{100} \quad X \quad \frac{100}{30} \quad = \frac{12}{30} = 40\%$$

Could drop NI to 4.8 and still match the previous ROE!!

Source: own example

As demonstrated above by leveraging the business without any other changes than €3 in net income (NI) the business could drop net Income to 4.8 and still match the previous ROE

See appendix B for a calculated case example.

3.5 IRR – the measure of performance

For better or worse, the IRR (Internal Rate of Return) is looked at as the measure of private equity performance. When people ask, “What is your return? In private equity they mean, “What is your IRR”

The IRR was designed to help measure a series of cash flows. The CFA (chartered financial accounting standard) think that the IRR is an appropriate measure for private equity. One of the reasons that IRR has risen to prominence is because of its relative simple to calculate on a computer. It takes into account the timing and magnitude of cash flows into and out of a private equity fund investment. Unlike a public manager, who receives cash at the discretion of his client, a private equity general partner calls capital when needed and distributes cash back somewhat randomly. This timing is a natural reflection of the process. The fund asks for capital from its investors as it finds and makes investments. So in theory if the money is not going to be put to work, it’s not being called from investors. As these portfolio investments make money, the GP is able to return capital and gains to the LP´s. The IRR helps take this into account, as it is both cash and time-weighted measurements.

The IRR is often debated and questioned as being with too many potential flaws to give a correct picture of performance of a private equity fund. Despite the common use of the IRR in the private equity industry, it should be noted that the IRR´s use as a general performance measure is problematic, due to its false reinvestment hypothesis. Indeed, the assumption is that cash flows generated by the fund, can be re-invested at an interest rate equal to the IRR. This of course makes no sense. Firstly it’s not possible to invest the distribution in a private equity fund with an identical return and secondly, this would lead to different re-investment rates for cash flows accruing at the same time. Due to these shortcomings it makes no sense to compare the performance of two private equity funds on the basis of their IRR – in fact to do so would give a false impression of their performance[20]

Large infusion of cash in the later lifetime of a fund (this is typically because funds get called on only when needed for investments) does not boost a positive IRR significantly. Since each cash flow carries a weight inversely proportional to its time in the investment, it’s possible to deliberately boost IRR by giving back cash back quickly. This is sometimes

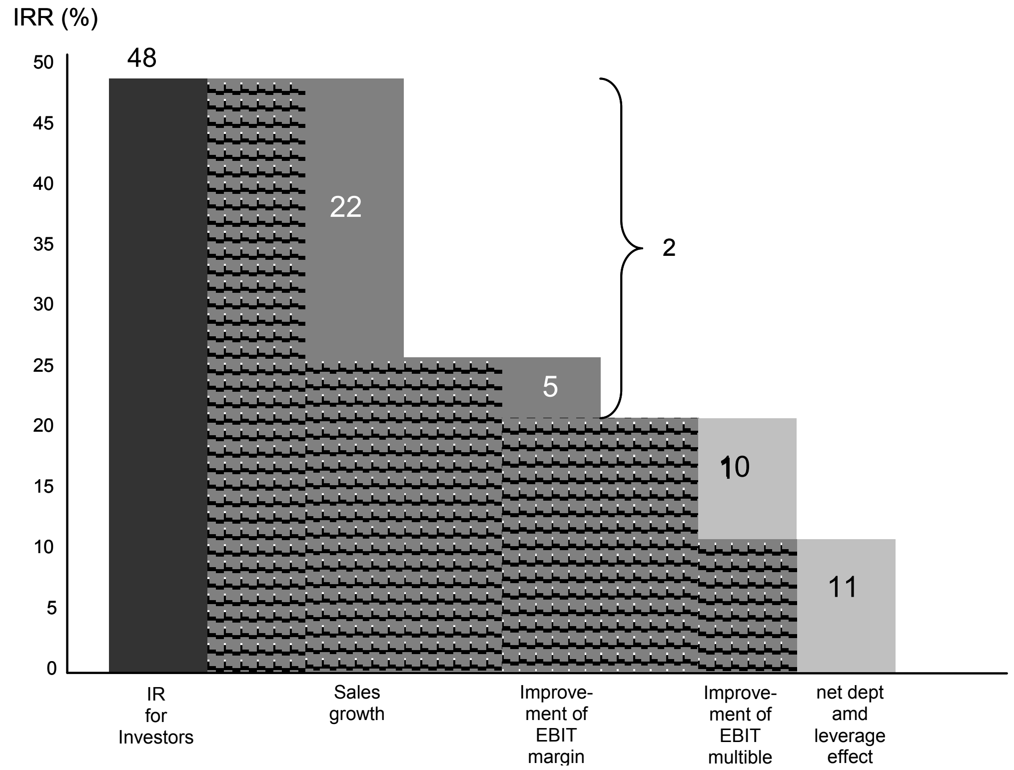
[20] For detailed analyses, “investing in private equity, fundamental principles, return and characteristics, Univ.-Prof. Dr. Christoph Kaserer

seen in first time funds that need to establish a good track record.

Therefore it's always needed to accommodate the IRR with some alternative questions and analytical approach, or simply ask questions to the individual performance of the portfolio company, and how returns has been distributed over a time period.

Since IRR has become a measure for private industry in terms of performance, it has also become key to fundraising. Investors will ask the fund to show their IRR and only top quartile funds will likely be able to attract big institutional investors. Academics are getting increasingly interested in understanding the performance behind the IRR measure in the private equity industry. Boston consulting Group conducted a study in 2008 where they analyzed 32 portfolio companies owned by seven European Private Equity firms. The study compares valuation from time of acquisition until exit. The key findings are shown in the chart below. Total IRR for the portfolio companies averaged 48 percent. The study is interesting in the sense that the performance was largely created by a mixture of sales growth and margin improvement, but also clearly demonstrates the effect of leverage, which was so common up until 2007.

Chart 12: PE - Asset class with high returns and value creation



Source: Boston Consulting Group 2008

To conclude on IRR before it gets too complicated the golden rule is without any mathematical solution that:

If deals make money, the IRR will be positive
If a deal looses money, the IRR will be negative
If a deal breaks even, the IRR will be zero

3.6 Value creation or making a quick buck

While private equity firms try to increase value of the company over time, buy-out deals are designed to make quick profits through management fees and financial engineering as well. Private equity is constantly under fire from all corners of the public for looking too much on short - term profit rather that improve the viability of the acquired companies over time. Lots of academic research actually prove otherwise, as seen in the Boston

Consulting paper from 2008 above, and testify that private equity plays an increasing important role in the financial system[21] and contributes to value creation in their portfolio business.

What might sometimes disturb this notion and mislead the public is case like the acquisition of Hertz Corporation for USD 15 billion in 2005 by a trio of private equity companies. The new owners took out a dividend of USD 1 billion, which came entirely from a new loan taken out by Hertz. With the dividend the trio earned back half their equity investment, while keeping their stake in Hertz intact.
Similarly, The Black stone Group paid USD 650 million in May 2004 for a part share in a US based chemical company. Just nine month later, it paid itself USD 500 million in dividends in addition to USD 45 million in advisory fees from Celanese.

Perhaps one of the most famous cases is the case of Warner Music Group, which was one of the world major record labels. It was bought for USD 1.25 billion in 2003 by a group of private equity firms comprising Thomas H. Lee Partners, Bain capital and Providence equity. Within months of being acquired, Warner Music made dividends, advisory fees and other payments of USD 1.43 billion for its new equity owners, and thereby defector paid off all the equity originally committed by the equity group, and a little more. The performance of Warner Music has been deteriorating with no improvements in revenues or profits ever since. But the equity investors could principally care less (might not be the case here)

3.7 Recent Trends

To conclude the chapter on International private equity industry lets turn to some of the recent trends impacting the industry and its future. The period from 2000 to mid-2007 saw low interest rates, a worldwide excess of capital, driven by a very buoyant credit market, rising corporate profits and a massive growth in structured credit products. The resulting easy liquidity in the global financial markets nourished a boom in the private equity market. A final feature of this easy money and leverage boom was that covenants associated with loan agreements became looser.

There are three major questions/trends that surround the industry at the moment.

[21] European Economic Advisory Group (EEAG) November 2009

- The consequence of heavy leveraging on future defaults
- Transparency and regulation
- And Taxation of the private equity industry

Should we expect given the extensive leverage employed by private equity funds in many boy-outs to create financial distress among private equity portfolio companies? The short answer is, it depends!

One issue is the investors who commit to private equity. They usually commit for a period of up to ten years, and cannot withdraw funds if a fund is doing poorly or if recession takes hold. Many of these investors provided long-term capital commitment[22] to private equity firms. While the funds they invested in might not be in trouble, the slowdown in the capital being returned to investors, coupled with economic reality of falling asset prices, falling liquidity and worsening macroeconomic conditions, some investors suddenly find themselves seriously overcommitted to private equity in terms of asset allocation. The consequence is withdrawal from committed capital, leaving the equity fund in potential liquidity troubles. Fundraising in 2008/09 was seriously impacted by this particular situation with institutional investors.

The private equity funds have been buying assets at record prices and taken large amount of debt, so what to expect and who will pay the price?

The PE funds made good use of the boom times to borrow at very low interest rates on relative good terms from banks and other providers of debt financing. Leveraged loans for private equity buyouts are priced relative to inter-bank interest rates such as LIBOR[23] the average spread on borrowing stayed very low, so much of the debt taken out was in fact extremely favorable. Another fact is that most of the loan coverage was relative long term, usually 7-10 years, and had a significant non-amortization proportion. Most corporate debt requires both interest payments and repayment of the principal loan during the lifetime of the loan. However much of the debt used to fund buy-outs has involved “bullet” repayment, which means that the loan is only repaid at the end of the term of the loan. These types of loan structures became popular during 2006 and 2007 and will provide equity firms with valuable flexibility, as long as the company can continue to meet its

[22] Committed capital is a promise to pay in when requested from the PE fund. So an investor made a legal promise to commit capital by request

[23] London interbank offered rate (LIBOR) is an interest used by financial institutions to determine a interest rate spread in borrowing.

required interest payments.
In summary many private equity funds will avoid financial distress while some will be eliminated by the crises. The one who really paid the price for this historic expansion of pricing and credit is ultimately the providers of this leveraged lending, like the investment banks, commercial banks and other financial institutions who invested in leveraged loans as they where pooled, trenched, structured and enhanced (or not) and distributed around the financial circus.

Within Europe considerable attention has been devoted to whether private equity should be regulated or not, and if so, how. The The Financial Service Authority undertook the first major review of the private equity industry in 2006[24]. This report broadly gave the industry a clean bill of health. But the industry is under constant public attention, and politicians that require more transparency and openness in the industry drive much of the debate. In the UK this led to the industry association, the BVCA (British Venture capital association) forming a high-level working group. Charred by Sir David Walker, the final recommendation of the Walker review acknowledged, that the industry should undertake rigorous evidence-based analyses of the economic impact of the private equity industry. The Walker review sparked lots of debate across Europe and many European countries have followed up with their own proposals, and the need for a common European guideline has been recognized by the EU and is under discussions. This has somewhat calmed the political storm. What will be the final outcome from the commission is still unclear, but it is certain to demand much more transparency for the private equity industry.

The last important trend relates to taxation issues. Two main issues has been raised regarding private equity: 1) the tax system actually encourages LBO´s and results in a reduction in national taxes revenues, and 2) whether the tax treatment of the private equity executives carried interests in the fund is appropriate and fair.
Most tax systems allow tax-deductibility of interest expenses on debt at the corporate level. And most tax systems treat equity financing less generously, by not allowing full tax deductibility of dividends payments or retained earnings. As a result most companies has an incentive to increase debt to reduce their post tax cost of capital. The tax benefit has of course to be weighted against potential cost of financial flexibility, or financial distress, but

[24] See FSA 2006

for many companies net gains from increasing leverage are significant, as demonstrated earlier in this thesis. Private equity firms often take full advantage of the tax deductibility of interest payments. This can significantly deduct the amount of corporate taxes flowing into the public coffers. As a result many countries both in Europe and elsewhere have started to question whether the tax system should allow full tax-deductibility for interest expenses. It is worth making one observation regarding the tax benefits of leverage. In large part the beneficiaries are likely to be the vendors of the companies that are required by the private equity firm, rather than the investors in the private equity funds, because leverage is a commodity that is available to all good private equity companies. Therefore it could be assumed, the main impact of rules to restrict the tax deductibility of debt may be felt by the owners of the companies rather than in the return reported by private equity firms.

The last hot subject when it comes to taxation issues is how to tax carried interests. This subject also became a matter of serious political debate north in Europe and across the atlantics (US) the issue is essential whether these carried interest (the share of profit made by the firm) should be treated as capital gain or income. This is a very complex issue. A full review of this issue is beyond the scope of this thesis, but a good summary is to be found by Lawton 2008. But the current tax treatment in many European countries appears very generous, especially when capital gain tax rates are reduced to longer - term holders of assets, which is normally what private equity GP´s does. The debate has somewhat lost momentum due to the current global crises and the subsequent lower income for the private equity industry GP´s – but the issue is not going to disappear and will for sure re-emerge in due time, once the economic situation has improved to the better.

3.8 Is private equity changing strategies?

The ongoing severe economic downturn and restriction in credit does not necessarily imply the end of the private equity industry. It has bounced back from other serious set backs in the 1980´and 1990´s. The fact that the private equity industry has more financial muscle than they used to, and closer linkage with other financial global actors increases the likelihood of a quick comeback. According to estimates made by the Collier institute at the London Business School, private equity companies sits on non invested (dry powder) funds of more than USD 1 Trillion, just waiting to find a home!
Yet private equity firms are likely to have to moderate their business strategies and

models. The area of mega buy-outs is largely over (at least for the time being) and the access to cheap money somewhat reduced. Instead market conditions might favor smaller and mid market firms, that has a proven track record in operational competencies and specific areas of expertise. Many private equity firms have turned to “distressed assets” in the wake of corporate defaults. Many firms have bought the debt (loans, mortgages shares etc.) from banks at heavily discounted prices. Some banks that were the same that provided the LBO loans are desperate to off load their balance sheet, also forced by new capital requirements (Basel II) that they are even lending the money to the buyers just to get the loans of their balances sheet.
With big investment banks and other institutional investors reluctant to commit new capital, private equity funds will have to find new sources of capital. They will in the future depend even more on big sovereign wealth funds, hedge funds, public pension’s funds and mutual funds. A major geographical shift in activity might also be foreseen. Asia was historically virgin territory for most of the big private equity funds. This has somewhat already changes and this trend will continue as Europe and US are saturating and the hunt for big profitable deals becomes more difficult. Especially the emerging market like china and India is attracting a lot of private equity funds, followed by the Middle East which is predicted to be a major player with home grown private equity firms, once they have overcome the current economic hick up in Dubai.

The end of private equity is defiantly not there. It has grown to be a major, very influential part of the global economy. Its power and impact on all levers of government and industry to financial powerhouses are very visible and will not disappear easily. As seen before in our history, every crisis has impact on certain part of the industry – but normality bounces back one day, perhaps with in a remodeled shape and feature, and this is also true for private equity.

Now lets turn the page and have a look at the Austrian capital market and its influence on the Austrian private equity industry. To fully comprehend why the Austrian equity industry is relative weak compared to other European markets it’s needed to take a deep look at the Austrian capital market also in a European context. The traditional deal channel for smaller medium seized private equity funds are smaller medium Enterprises (SME), so the sector also constitute part of the capital market study. It’s relevant in order to fully understand the macro environment in which the Austrian private equity has to operate.

4.0 The Austrian Capital Market

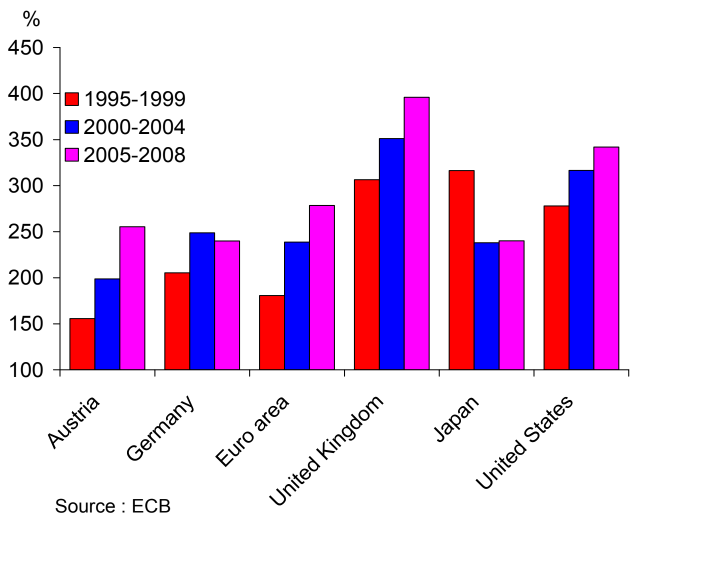
In the post-war era the government played an important role in the development of a social market economy. However, in the early-1990s, state-owned firms started to operate largely as private businesses and the government wholly or partially privatised many of these firms[25]. But, although the privatisation drive was successful, the state via its holding company ÖIAG, still operates some firms in utilities and services.

The Austrian economy has often been typified in the past as highly dependent on Mittelstand firms that are typically family owned. These are often small or medium-sized enterprises within the terms of the definitions used internationally and, for financial capital, heavily dependent on retained earnings, bank loans or quasi-equity forms of capital such as silent partnerships or profit certificates.

In the period since accession to the EU the size of the securities markets in Austria has expanded rapidly. In the mid-1990s the outstanding stock of securities of all kinds (government and corporate debt; equity) stood at around 150% of Austrian GDP. As shown in Chart 1 this was lower than any of the key comparator economies. For example the ratios for the Euro area as a whole and for Germany at that time were over180% and 200% respectively, while for the US and the UK the ratios were over 275% and 300%. The data for 2005-08 for Austria show a sharp rise to 255%, with the rise in the stock of Austrian securities relative to GDP outstripping that in the large economies and the Euro area as a whole. However while the Austrian securities markets are now a little bigger relative to the size of the overall economy than those in Germany, the growth has lagged that in Ireland, Spain and Greece over the period since the mid-1990

[25] Interview: Dipl. Ing. Dr. Stefan Zapotocky, former CEO Vienna Stock exchange.

Chart 13: Capital market size in relation to GDP



Source: ECB 2009

The outstanding value of government bonds in Austria amounted to just over €150billion at the end of 2009 (Chart 14). This makes it one of the smaller government bond markets in the Euro area and even in relation to GDP Austria's government bond market is smaller than that for the Euro area as a whole and in line with that of Germany. This potential reduces concerns that an over-large stock of government will make it difficult for the private sector to access the securities markets on reasonable terms.

Chart 14: Government debt securities outstanding (Euro billion) Dec 2009

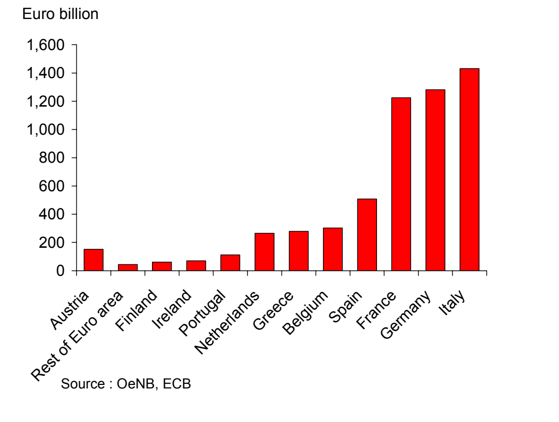
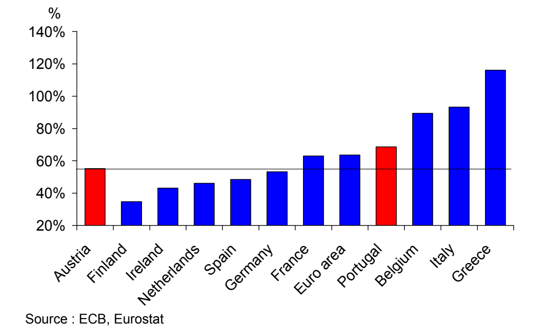


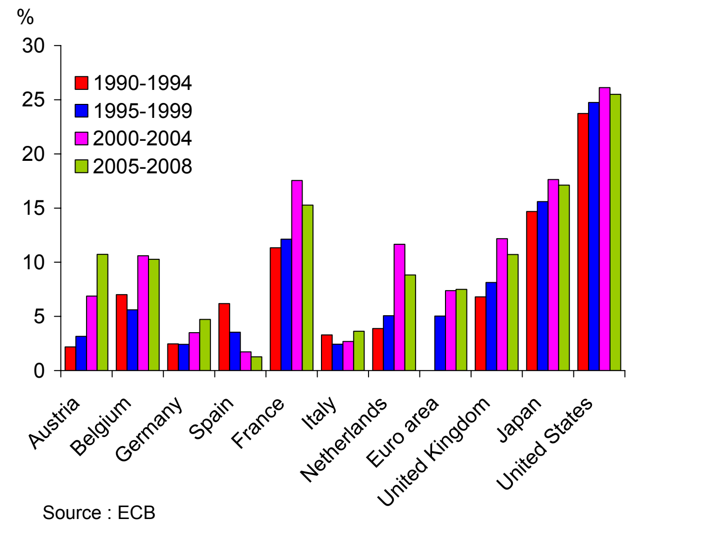
Chart 15: Government debt securities as % of GDP (Dec 2009)



Source: OeNB, ECB, Eurostat 2009

Austria possesses one of Europe's largest corporate bond markets (Chart 16). With the exception of Portugal and France, the outstanding value of corporate bond securities in Europe relative to GDP lags well behind that in the US and Japan. The growth in the Austrian corporate bond market is a recent phenomenon. In the 1995-99 periods the value of the Austrian corporate market was only 3% of GDP, below the ratios for the Euro area as a whole of 5% and for France of 12%. By 2005-08 the Austrian ratio had risen to 11%, well ahead of the Euro area average of under 8% and equivalent to the figure for the UK

Chart 16: Corporate bond market size in relation to GDP



Source: ECB 2009

In contrast to the corporate bond market, as shown in Charts 5 and 6, Austria's stock market capitalisation is small in both absolute terms relative to other economies and in relation to GDP. At December 2009 the capitalisation of the Austrian equity market stood at €77billion. This is equivalent to only 28% of Austrian GDP, similar to the ratios in Ireland and Italy, but well below those in the US (102%), the UK (124%) and Switzerland (206%). This ratio has however more than doubled from its 1995 value of 13%. In relation to GDP this growth matches that in Germany, but lags Switzerland, Greece, Norway and Spain.

Chart 17: Stock market capitalisation (Euro billion) Dec 2009

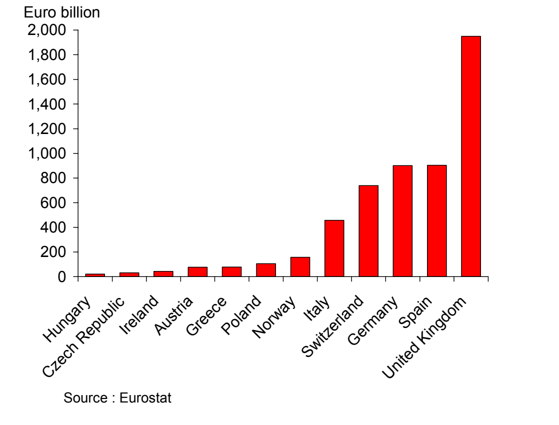
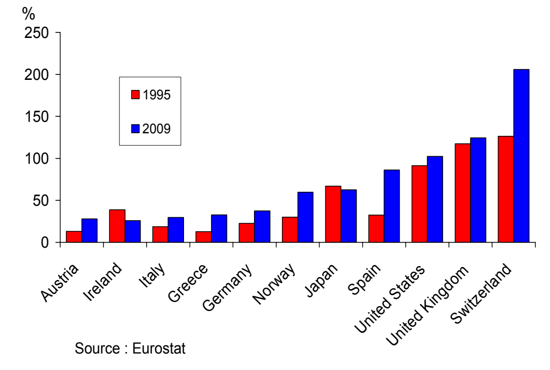


Chart18: Stock market capitalisation as % of GDP (Dec 1995 & 2009)



Source: Eurostat 2009

The ownership structure of companies listed on the Austrian stock exchange tends to be much more concentrated than in the US or the UK. According to research published in 2004[26] the median largest shareholder on the Austrian stock market owns more than 50% of a company's market capitalisation (similar to Germany), while in the US or UK the corresponding value amounts only to about 10% to 20%. In addition this research points to substantial differences in the type of owner in Austria. In the two Anglo-Saxon markets ownership tends to be by institutional investors, whereas in Austria other non-financial corporations tend to dominate share holdings.

Austrian financial institutions are playing a key role in the financing of businesses and investments in Eastern Europe. The Vienna Stock Exchange was/is building alliances across Eastern Europe, taking stakes in a number of emerging bourses and creating indices covering Central and Eastern European stocks that can form the base for structured products for investors. Direct cross-border lending to corporate customers by Austrian banks has also expanded sharply over the last few years. Cross-border lending to corporate borrowers in Eastern Europe more than tripled between 2002 and 2008 from €15billion to €67billion in 2008[27]. As well as building on long-standing cultural ties this lending is also supporting foreign direct investments by Austrian businesses in Eastern Europe. Exposure to problematic loans in Eastern European economies hit by the crisis,

[26] Gugler, K., D. Mueller and B. Yurtoglu. 2004. Corporate Governance and Globalization. In: Oxford Review of Economic Policy 20(1). 129—156
[27] Direct Cross-Border Lending by Austrian Banks to Eastern Europe, Financial Stability Report, June 2009, OeNB

could however act as an additional constraint on bank lending in Austria over the next few years.

4.1 Financial liabilities of businesses in Austria

Eurostat and the Austrian Central Bank publish national accounts data on the total liabilities on non-financial corporations. This data provides useful insights into the financing of business enterprises.

According to the Eurostat data the total liabilities, made up of loans, debt securities, equity, other accounts payable and financial derivatives, of Austrian non-financial companies amounted to €502billion, 178% of GDP in 2008. Of this total, long-term liabilities[28], amounted to €426billion, or 85% of total liabilities and 151% of GDP.

Table 1 below shows the breakdown of these liabilities. Nearly two-fifths (38%) of the capital of Austrian non-financial companies was made up of other equity (see Box 1). The second biggest share is made up of long-term loans (29%), while long-term debt securities and quoted shares accounted for only 7% and 6% respectively.

[28] Long-term liabilities are defined here as total liabilities less short-term loans, short-term securities and other accounts payable, including trade credits.

Table 1: Austria non-financial corporations - liabilities

	2007		2008	
	Euro millions	% Of total liabilities	Euro millions	% of total liabilities
Short-term debt securities	*178*	0.0%	*47*	0.0%
Long-term debt securities	30,069	5.8%	33,038	6.6%
Financial derivatives	*7*	*0.0%*	*7*	*0.0%*
Short-term loans	*53,454*	10.3%	*59,576*	11.9%
Long term loans	137,044	26.4%	143,813	28.6%
Quoted shares	73,888	14.2%	30,025	6.0%
Unquoted shares	30,806	5.9%	30,393	6.1%
Other Equity	178,934	34.4%	188,684	37.6%
Other accounts payable	*15,442*	3.0%	*16,480*	3.3%
Short-term liabilities	*68,904*	*13.3%*	*76,063*	*15.2%*
Long-term liabilities	450,741	86.7%	425,952	84.8%
Total liabilities	**519,644**		**502,015**	

Source: Eurostat 2009

The liabilities of Austrian enterprises grew much more quickly than overall GDP in the period from 1995 to 2008. In aggregate, total liabilities grew at an annual rate of 8.5%, with long-term liabilities growing by 9.4% per annum in this 13-year period. This compares with growth of nominal GDP at annual rate of 3.4%. While all the constituent parts of long-term liabilities identified in the national accounts grew faster than nominal GDP over the period, there were marked differences across different types of capital. The stock of unquoted shares grew at an annual rate of nearly 16%; other equity and long-term debt securities grew at an annual rate of over 12%, while quoted shares and long-term loans showed lower growth rates of 7% and 6% respectively.

As a result of these differential growth rates the shares of different sources of capital for Austrian non-financial businesses shifted markedly over the period from the mid 1990s. The largest decline was in the share taken by long-term loans, which fell from 39% of the total in 1995 to 29% in 2008. Over the same period the most significant gain in share was made by other equity, which grew from 24% to 38%. The long –term debt securities share rose from 4% to 7%, while the quoted equity securities share fell from over 7% to 6%.

It is, however, worth noting two potential distortions in this picture when the data are viewed from the perspective of long-term trends in the financing of economic activity by non-financial firms in Austria. First, the “mark-to-market” effect of the global downturn in quoted equity prices in 2008 sharply reduced the long-term growth rate in value of the stock of quoted equity securities. Over the 12 years to 2007 the annualised growth rate in the value of quoted equity securities of 16.6% nearly matched the 17.2%[29] achieved by other equity.

Secondly, the other equity parts include Special Purpose Entities. In the middle of the last decade there were strong flows into domestic Austrian holding companies formed by foreign investors where the aim was to holding direct investment abroad. For example this type of transaction might have been part of a securitisation process. These Special Purpose Entities do not undertake any significant economic activity in Austria. Statistics from the Austrian central bank show that, in 2008, Special Purpose Entities accounted for nearly one-third of the other equity component of the liabilities of non-financial corporations and for 14% of all liabilities of non-financial corporations in Austria.

[29] The 1995-2007 annual growth rates for other categories of capital were impacted much less by the 2008 financial crisis. The respective annual growth rates over this period are13% for other equity; 12.4% for long-term debt securities; and 6.1% for long-term loans.

Box: What is included in "other equity"?

The European System of National and Regional Accounts define shares and other equity as financial assets, except mutual fund shares, which represent property rights on corporations or quasi-corporations. These financial assets generally entitle the holders to a share in the profits of the corporations or quasi-corporations and to a share in their net assets in the event of liquidation.

Other equity is made up of:

a) all forms of equity in corporations, which are not shares:

(1) the equity in incorporated partnerships subscribed by unlimited partners;

(2) the equity in limited liability companies whose owners are partners and not shareholders;

(3) the capital invested in ordinary or limited partnerships recognised as independent legal entities;

(4) the capital invested in co-operative societies recognised as independent legal entities.

b) investments by general government in the capital of public enterprises, whose capital is not divided into shares, which by virtue of special legislation are recognised as independent legal entities;

c) government investments in the capital of international and supranational organisations, with the sole exception of the IMF, even if these are legally constituted as companies with share capital (e.g. the European Investment Bank);

d) the financial resources of the ECB provided out of contributions by the national central banks;

e) capital invested in financial and non-financial quasi-corporations;

f) the financial assets that non-resident units have against notional resident units and vice versa.

Source: http://circa.europa.eu/irc/dsis/nfaccount/info/data/esa95/en/een00251.htm

4.2 Liabilities of non financial corporations - international context

Sources of capital to Austrian non-financial corporations differ from the European average in a number of ways:

- **Total liabilities** of non-financial corporations in Austria at just under 180% in 2008 are a little below the EU average of nearly 200%.
- There is less reliance on short-term financing by non-financial corporations in Austria. **Short-term company liabilities** amounted to 27% of GDP in Austria in 2008, but to 45% of GDP at the EU level.
- Both **quoted and unquoted shares** form a much smaller portion of the liabilities of Austrian non-financial corporations. In the EU as a whole both account for around 18% each of aggregate corporate liabilities. In contrast in Austria they each account for 6% of corporate liabilities.
- This low proportion of quoted and unquoted shares appears to be compensated for by the large share taken by **other equity** –38% of liabilities and equivalent to 67% of GDP in 2008. This compares with ratios of 11% and 20% for other equity at the EU level. And even when the potential distortions caused by Special Purpose Entities are taken into account, other equity still forms a disproportionately high share of the total liabilities of non-financial corporations in Austria.
- **Long-term loans** accounted for a higher proportion of total liabilities and of GDP in Austria in 2008 – representing 50% of Austrian GDP compared with 45% for the EU.
- Austrian non-financial companies were somewhat more reliant on **long-term debt securities** in 2008 than companies in the EU as a whole, with the stock of these securities representing 12% of GDP compared with 8% for the EU.

Table 2: Austria – capital sources in a European[30] context

2008	Austria		EU	
	% of total liabilities	% of GDP	% of total liabilities	% of GDP
Short-term debt securities	*0.0%*	*0.0%*	*1.6%*	*3.1%*
Long-term debt securities	6.6%	11.7%	4.4%	8.3%
Financial derivatives	*0.0%*	*0.0%*	*0.4%*	*0.9%*
Short-term loans	*11.9%*	*21.1%*	*14.1%*	*27.0%*
Long term loans	28.6%	51.0%	24.8%	50.1%
Quoted shares	6.0%	10.7%	17.7%	34.7%
Unquoted shares	6.1%	10.8%	18.6%	37.6%
Other Equity	37.6%	66.9%	10.5%	19.6%
Insurance technical reserves	0.0%	0.0%	1.3%	2.2%
Other accounts payable	*3.3%*	*5.9%*	*6.6%*	*13.8%*
Short-term liabilities	*15.2%*	*27.0%*	*22.7%*	*44.8%*
Long-term liabilities	84.8%	151.1%	77.3%	152.7%
Total liabilities		178.1%		197.5%

Source: Eurostat, ONS 2009

The growth in the total liabilities of the non-financial corporate sector in Austria since EU accession in 1995 has been faster than for the EU as a whole. As shown in Table 3, the ratio of non-financial corporate liabilities to GDP has grown by 83 percentage points of GDP compared with growth of 55 percentage points at a EU level.

[30] Eurostat data at this level of disaggregation is not available for Bulgaria, Estonia, Ireland, Italy, Cyprus, Latvia, Luxembourg, Malta and Slovakia. Figures for the UK from the Office for National Statistics have been added to the Eurostat data. Together the 18 member states included in the table accounted for 83% of EU GDP in 2008.

The change in the structure of these liabilities has also been more marked in Austria since 1995:

- The **share of other equity** has increased by 14 percentage points compared with only 3 percentage points at the EU level
- Reliance on **loans** has declined in Austria while increasing in the EU as a whole. The share of long-term loans in the total declined by 10 percentage points in Austria compared with a 2-percentage point increase in the EU. For short-term loans the decline in Austria of 8 percentage points compares with a 2-percentage point gain in the EU.
- There has been a shift to **long-term debt securities** in Austria of over 2 percentage points since 1995 compared with no change at a EU level.
- The share of total non-financial corporate liabilities accounted for by **unquoted equities** has risen somewhat faster in Austria than in the EU as a whole.

Table 3: Evolution of liability structure 1995-2008

1995-2008	Austria	EU
	Change in share of total liabilities	Change in share of total liabilities[31]
Short-term debt securities	*-0.1%*	*0.9%*
Long-term debt securities	2.3%	0.1%
Financial derivatives	*0.0%*	*0.3%*
Short-term loans	*-8.0%*	*1.8%*
Long term loans	-10.2%	2.0%
Quoted shares	-0.8%	-6.2%
Unquoted shares	3.4%	2.0%
Other Equity	13.9%	3.1%
Insurance technical reserves	0.0%	-0.9%
Other accounts payable	*-0.5%*	*-3.1%*
Growth in total liabilities as percentage points of GDP	82.6%	54.9%[32]

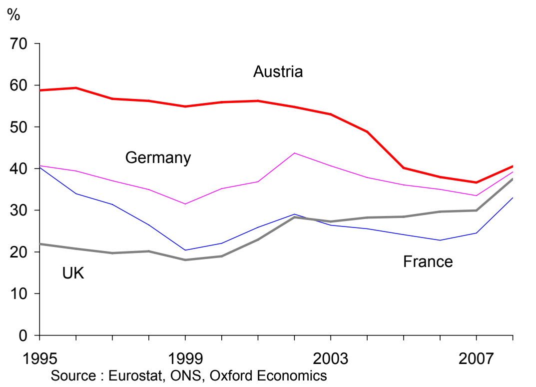
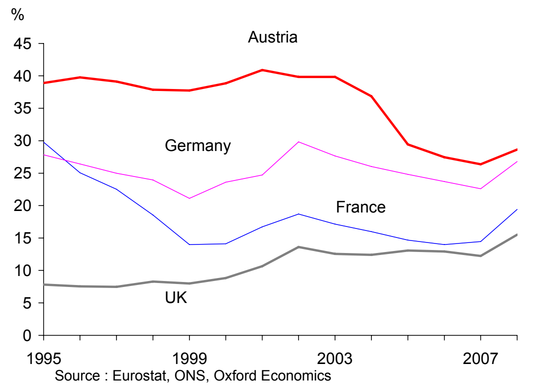
Source: Eurostat and ONS 2009

Cross-country comparisons also yield insights to the unique features of and trends in the Austrian capital market.

In the past Austria showed an unusually high degree of reliance on loan finance. In 1995 loans accounted for 59% of the liabilities of non-financial corporations in Austria, above the share in any other major EU member state[33], with short-term loans representing 20% of corporate liabilities and long-term loans 39%. By 2008 share of loans in total liabilities in Austria had fallen to 41%, around the average for the comparator group of Member States. Greece, Spain, Denmark, Italy and Portugal now all have a greater share to total liabilities in loans. Of the big EU economies only France (33%) showed a markedly lower

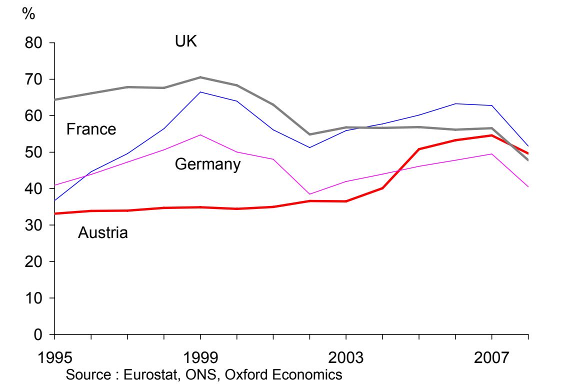
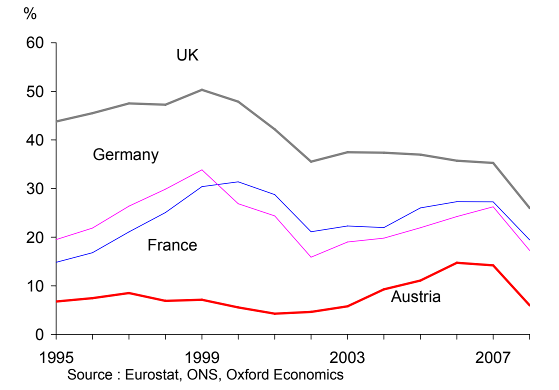
[31] Based on data for Austria, Belgium, France, Germany, Greece, Hungary, Poland, Spain, Sweden, UK.
[32] In addition to the Member States covered in the share of liabilities measure, includes Finland, Italy, Lithuania, Portugal and Slovakia
[33] Data is available for total loans for, in rank order, Austria, Denmark, Italy, Greece, Finland, Sweden, Germany, France, Netherlands, Spain, Belgium, Portugal, Hungary, the UK and Poland.

reliance on loan finance in 2008. Similarly the picture for long-term loans also shows a decline from the top of the EU ranking to around average in the period from 1995 to 2008.

Chart 18: Share of loans in total liabilities of non-financial corporations	**Chart 19: Share of long-term loans in total liabilities of non-financial corporations**
	

Source: Eurostat, ONS, Oxford Economics 2009

Austria's high ranking in terms of the use of loan finance in 1995 was reflected in a second bottom position among major EU member states for the proportion on non-financial corporate liabilities accounted for by all forms of equity finance. With only a third of liabilities in the form of equity, Austria had a lower exposure to this type of corporate liability than any of the comparator group except Denmark. The average reliance on equity by individual Member States was around 50%, with Portugal, the UK, Hungary and Poland all well above this mark. However, by 2008 Austria showed an above average dependence on equity finance – with Italy, Germany, the Netherlands and the UK all recording a smaller share of the liabilities of non-financial corporations in the form of equity.

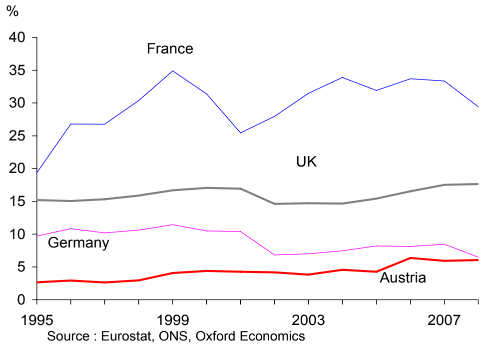
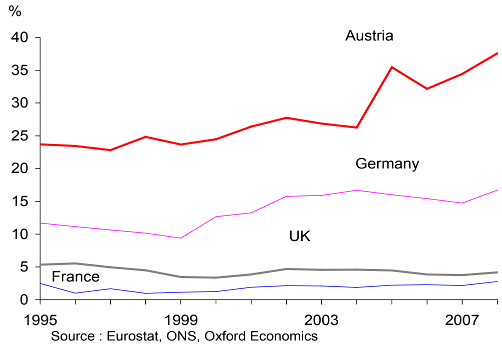
Chart 20: Share of equity in total liabilities of non-financial corporations	Chart 21: Share of quoted shares in total liabilities of non-financial corporations
	

Source: Eurostat, ONS, Oxford Economics 2009

This look at the aggregate equity position hides important trends in respect of different forms of equity. Despite the Austria's low ranking in the use of all forms of equity in 1995 relative to other member states, it ranked top in the share of total liabilities (24%) accounted for by other equity. Only Hungary rivalled Austria on this measure with a 23% share, with Germany in third place with a 12% share[34]. Correspondingly, quoted shares (7%) and unquoted shares (3%) formed a lower share of total liabilities than in any of the member states for which data is available, except Poland and Hungary.

This very low use of quoted and unquoted forms of equity is a continuing feature of the structure of Austrian corporate liabilities. In 2008 these forms of equity each accounted for 6% of total liabilities of non-financial corporations in Austria. For quoted shares this proportion is the second lowest across the compared group of Member States behind Hungary. As shown in Chart 21, quoted shares made up between17% and 26% of corporate liabilities in 2008 in the biggest EU economies.   In terms of unquoted shares, Austria ranks lowest, just behind Germany, where unquoted shares account for 7% of corporate liabilities. The average proportion of liabilities of non-financial corporations taken up by unquoted shares in the individual Member States is around 18%, with France (29%), the Netherlands (24%), Spain (23%) and Finland (23%) at the top of the ranking on this measure.

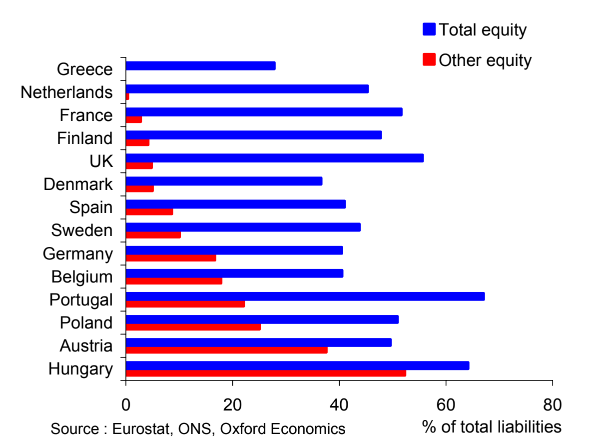
[34] No disaggregated data on type of equity is available for Italy.

Chart 22: Share of unquoted shares in total liabilities of non-financial corporations	Chart 23: Share of other equity in total liabilities of non-financial corporations
	

Source: Eurostat, ONS, Oxford Economics 2009

Charts 22 and 23 illustrate Austria's weak position in the use of other equity by non-financial corporations. Only Hungary shows a greater growth in this category of liabilities, though other equity also makes up a notable share of total equity in Germany, Portugal, Poland and Belgium. To some extent this is due to the activity of Special Purpose Entities that chose to domicile in Austria but who do not undertake meaningful real economic activities within Austrian borders.

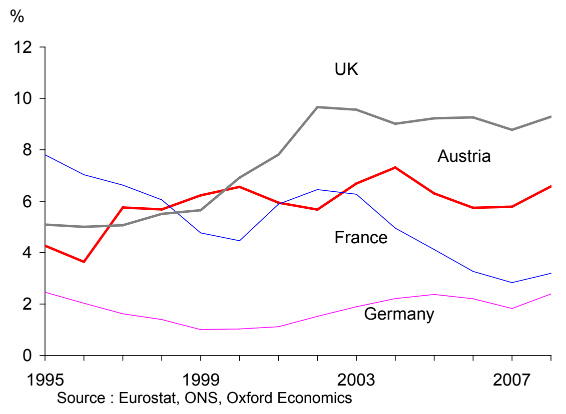
Chart 24: Share of total equity and other equity in liabilities of non-financial corporations



Source: Eurostat, ONS, Oxford Economics 2009

Austria is near the top of the ranking for the use of long-term securities other than derivatives (corporate debt securities) as a means of financing non-financial corporations. In 1995, with 4% of corporate liabilities accounted for by long-term debt securities, Austria only lagged France (8%) and the UK (5%). This high ranking was still in place in 2008, with 7% of Austrian liabilities of non-financial corporations in this category, and only Greece 11% and the UK 9% having heavier weightings to this form of capital.

Chart 25: Share of long-term debt securities in total liabilities of non-financial corporations



Source: Eurostat, ONS, Oxford Economics

4.3 Sources of long-term loans in Austria

While no data seems to be available on the counterparties to the liabilities of non-financial corporations in the national accounts, data covering the asset position of different sectors of the economy provides some valuable insights. For example, while non-financial corporations in Austria have reduced their reliance on long-term loans in recent years, the changing mix of long-term loan assets of the other sectors of the economy suggests some important changes are happening in the sources of loan finance for Austrian businesses.

Long-term loans from the banks to the other sectors of the Austrian economy stood at 116% of GDP in 2008, up by 36 percentage points of GDP, or by 126% in absolute terms since 1995. But this growth in long-term loans from the banks has been outstripped by growth in foreign loans, up 620% since 1995, and from non-bank financial intermediaries, up 252%. Against this, both the public sector and insurance companies & pension funds have seen value of their outstanding loans fall. Between 1995 and 2008 long-term government loans as a proportion of GDP fell by over 5 percentage points to 8% of GDP. The fall was even more marked for insurance companies and pension funds where outstanding long-term loans fell by 66% or nearly 6% of GDP.

Thus, though long-term loans have shown signs of diminishing in importance for the business sector in Austria, the data suggest that banks, foreign lenders and non-bank segments are increasing their importance as sources of available long-term lending.

Table 4: Austria – long-term loan assets by sector

	Long-term loans (assets) as % of GDP 2008	Change in long-term loans (assets) percentage points of GDP 1995-2008	% Change in long-term loan assets
Other monetary financial institutions	116.0	36.3	126%
Rest of the world	15.8	12.4	620%
General government	8.1	-5.3	-6%
Non-financial corporations	5.1	4.5	1170%
Other financial intermediaries	3.3	1.9	252%
Insurance corporations & pension funds	1.6	-5.7	-66%

Source: Eurostat 2009

5.0 The Austrian SME sector

Austria has fewer businesses relative to its population than the average for the EU. While Small and Medium Sized Enterprises[35] (SMEs) constitute the same proportion of total businesses as across the EU, overall there are around 33 businesses in Austria for every 1,000 inhabitants, compared with 40 for the EU as a whole. Within the SME sector Austria possesses a disproportionately large share of small and medium sized enterprises, but a smaller share of micro enterprises.

Small and Medium sized businesses contribute a larger share of Austrian value-added than the average across the European Union, though the absolute levels of value added they produce are below the average for their peers across Europe, shown by a lower ratio of value added to business population share in Austria than for the EU as a whole.

Table 5: Size structure of Austrian businesses

	Number of enterprises			Value-added	
	Number	%	EU average	%	EU-average
Micro	239,193	87.4%	91.8%	19.4%	21.1%
Small	29,065	10.6%	6.9%	20.5%	19.0%
Medium	4,466	1.6%	1.1%	21.7%	17.8%
SMEs	272,724	99.7%	99.8%	61.6%	57.9%
Large	935	0.3%	0.2%	38.4%	42.1%

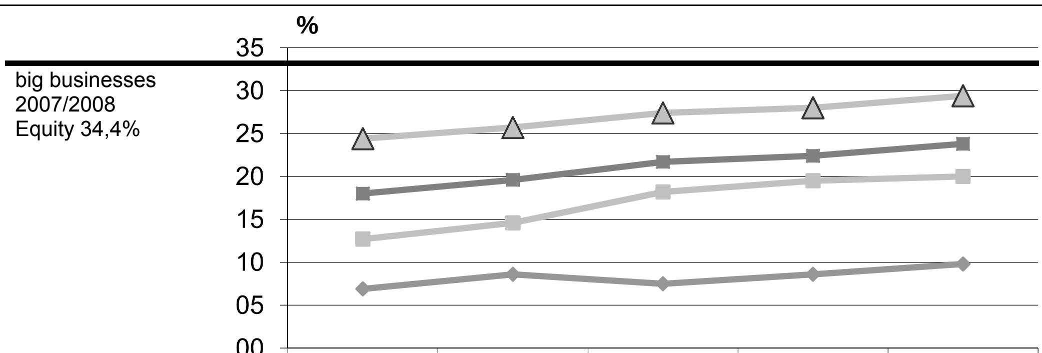
Source: Eurostat SBS data base, 2004 and 2005 data

In common with findings for other economies, data from the Austrian Institute for SME Research shows that there is a strong link between business size and use of loans as a source of capital. According to data for 2008 bank loans accounted for over half of the capital of Austrian enterprises with a turnover in the range €500,000 to €1million, with one-third of this amount provided by short-term loans. This reliance on loans, particularly long-term loans, fell to less than 40% for businesses in the turnover range €4-€7m.

[35] According to the European Commission Enterprises qualify as micro, small or medium-sized if they fulfil maximum ceilings for staff headcount and either a turnover ceiling or a balance sheet ceiling as follows. Micro enterprises are defined as having under 10 staff and turnover below €2million per annum or a balance sheet total of less than €2million. Small enterprises are defined as having under 50 staff and turnover below €10million per annum or a balance sheet total of less than €10million. Medium-sized enterprises are defined as having under 2500 staff and turnover below €50million per annum or a balance sheet total of less than €43million.

Another feature of the SME sector is its relative weak equity ratio. This is particular outspoken among very small businesses. This is hardly unusual as this type of business very often is start up or single run type of enterprises. However in general the equity ratio is on average quite low also to European average (see chart 26) and pose another potential problem. How are these businesses going to survive the economic crises? How are they going to obtain credit with banks increasingly under pressure to reduce risks? It also potentially tells the story of Austrian SME sectors lack of equity culture. Traditionally this sector has relied on bank credits to get started, and to finance growth. The banks have helped to nurse this culture by their strong regional influence and deep roots in the SME sector across all national states. Particular the Raiffeisen dynasty has strong control and participation across all sectors of the Austrian industry[36].

Chart 26: Equity ratio development by sub segment 2003/04 – 2007/08



	2003/04	2004/05	2005/06	2006/07	2007/08
very small business	07	09	08	09	10
small business	13	15	18	20	20
medium businees	24	26	27	28	29
small and medium-sized companies	18	20	22	22	24

Equity ratio = booked raito as % of total liabilities

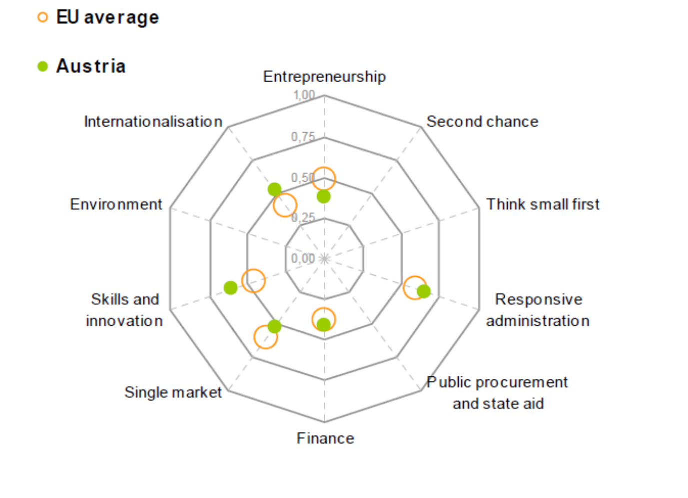
Source: KMU in Österreich: "Eigenkapitalausstattung und betriebswirtschaftliche Position der KMU vor Beginn der Finanzkriese"; (www.kmuforschung.ac.at)

[36] http://www.news.at/articles/0736/30/182708/raiffeisen-wirtschaft-m... Raiffeisen beherrscht Wirtschaft

The European Commission's Small Business Act Fact Sheet for Austria provides a "policy radar" diagram (Chart 27) of the performance of the SME sector in Austria. Based on over 70 statistical indicators[37], Austria is shown to be outperforming in terms of "skills and innovation" and "internationalisation"; underperforming with respect to "entrepreneurship" and "single market"; and matching the European average for "finance" and "responsive administration".

[37] For a discussion of the methodology used to construct the policy radar diagram see: http://ec.europa.eu/enterprise/policies/sme/files/craft/sme_perf_review/doc_08/spr08_methodology_note_fact_sheets_en.pd

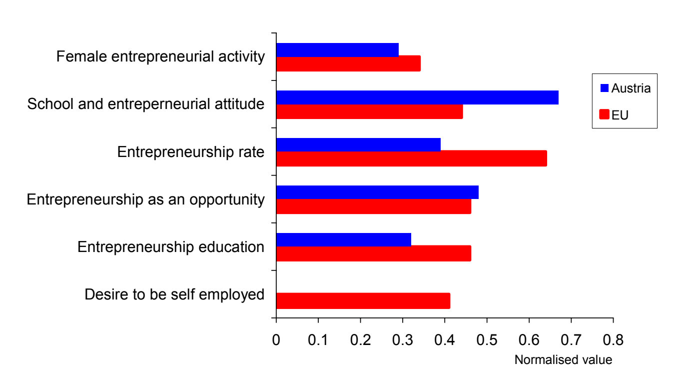
Chart 27: Austria's small business performance profile



Source: European Commission, SBA Fact Sheet Austria 2008

In the context of the Austrian capital market the indicators used to construct the measures in the radar diagram for entrepreneurship and finance are of particular interest. Chart 29 compares the values for the indicators on entrepreneurship for Austria with those for the EU as a whole.

Chart 29: Entrepreneurship indicators



Source : European Commission, Spring 2008 SME Indicators

While on the aggregate measure of entrepreneurship Austria scores around the EU average, the picture is much more varied for individual indicators. In particular, Austria scores very highly on the extent to which school education helps to develop an entrepreneurial attitude or sense of initiative; the extent to which entrepreneurship is seen as an opportunity in Austria is also marginally ahead of the average for the EU. However, Austria scores particularly poorly on the desire to become self-employed and is also weak in terms of participation in specific courses on entrepreneurship or setting up a business.

Similarly the average score achieved by Austria for finance combines areas of particular strength and weakness. As shown in Chart 30, Austria scores poorly for:

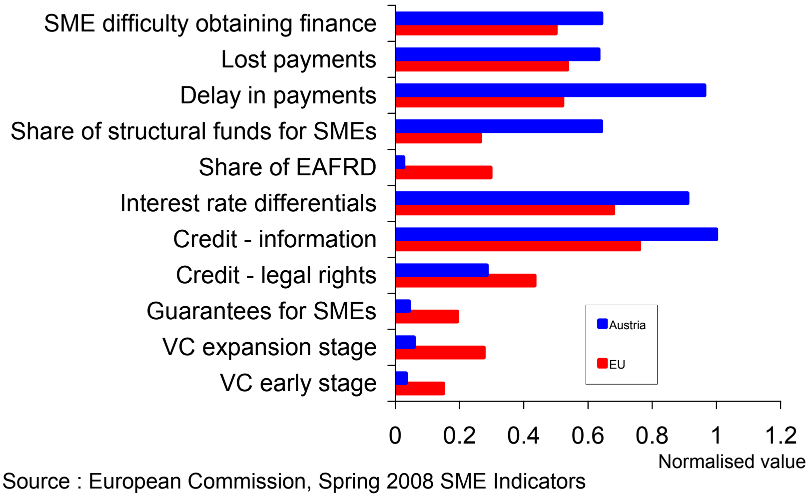
- The availability of venture capital at both early stage and expansion stages of business development
- The availability of guarantees covering finance for start-ups and SMEs
- Support for business creation and development from the European Agricultural Fund for Regional Development
- The strength of legal rights (see page 65 below).

Against these weaknesses Austria possess advantages compared with its European partners in:

- Below average delays in SMEs obtaining payment for completed contracts
- Share of EU structural funds dedicated to stimulating entrepreneurship and business development
- Depth of credit information (see below)
- The share of SMEs who have experienced difficulty in obtaining finance[38].

[38] Data from the November 2006 – January 2007 Flash Eurobaraometer

Chart 30: Finance indicators



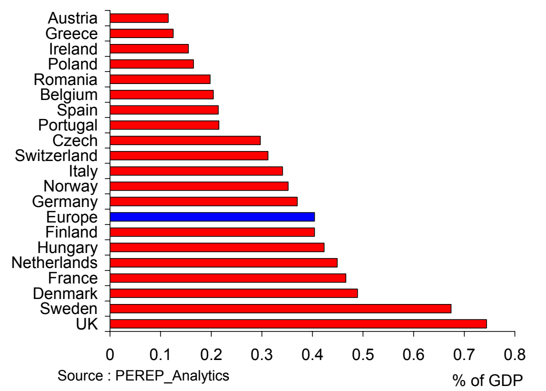
Source : European Commission, Spring 2008 SME Indicators

6.0 Role of private equity in Austria

The minor role played by private equity in Austria is underlined by the latest data from the European Venture Capital Association (Charts 31-33). These show that the low ranking of Austria in the 2007 data that underlies the European Commissions policy radar chart (Chart 27) persisted into 2008.

When private equity investment is expressed as a percentage of GDP Austria ranks last among European countries for which data is collected, with private equity investments equivalent to only 0.1% of GDP. By contrast, the top ranked economies, the UK and Sweden, enjoy ratios around seven times greater than that for Austria; and, only Ireland and Greece, along with Austria, recorded ratios below 0.15% in 2009.

Chart 31: European all private equity investments as a % of GDP 2008

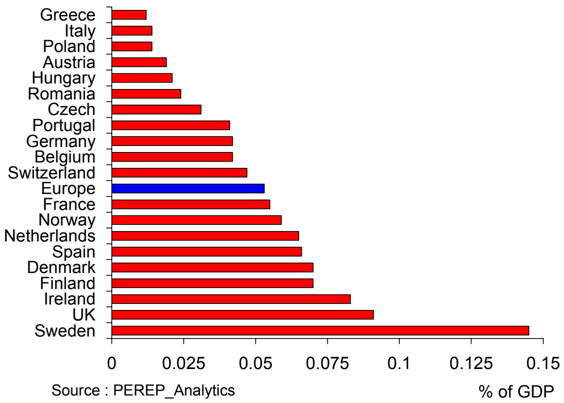


Source: PEREP_Analytics 2009

Austria ranks slightly higher when the comparison for 2008 is restricted to the venture capital component of private equity[39]. On this measure Austria outperforms Greece, Italy and Poland, however for Europe as a whole ratio of venture capital investment to GDP in 2008 was over 2.5 times higher than in Austria and 7.5 times higher in Sweden at the top of this ranking.

[39] In 2008 venture capital investments accounted for 13% of private equity funding in Europe but 17% of the total in Austria

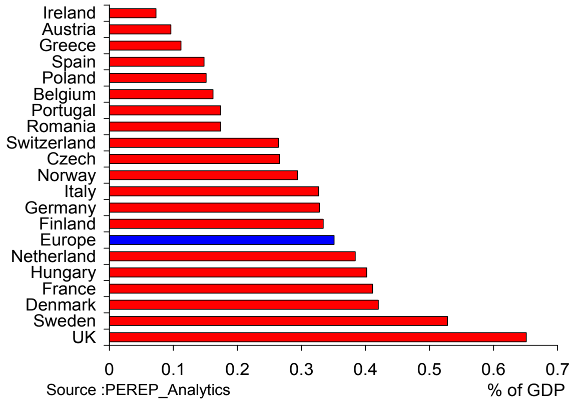
Chart 32: European venture capital investments as a % of GDP 2008



Source: PEREP_Analytics 2009

In terms of buyout investments Austria lags all the European comparator economies with the exception of Ireland, with Greece the only other country near to the Austrian figure. Buyout investments as a proportion of GDP in Europe as a whole were nearly 4 times higher than in Austria in 2008 and nearly 7 times higher in the UK at the head of the rankings.

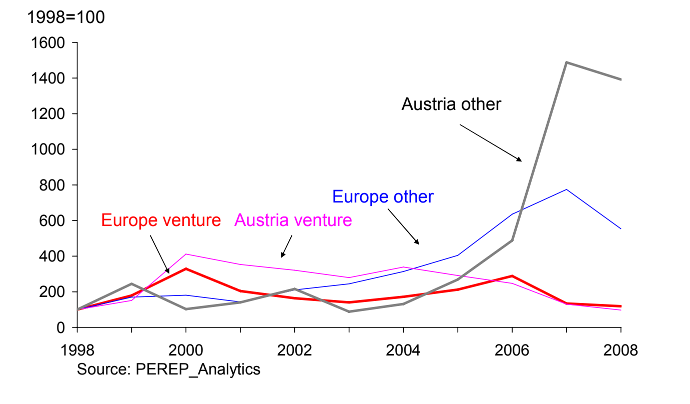
Chart 33: European buyout investments as a % of GDP 2008



Source: PEREP_Analytics 2009

This weakness in private equity in the use of private equity is a persistent feature of the Austrian capital market over the last decade. While the growth of venture capital financing in Austria has matched the average for Europe as a whole and the growth in other forms of private equity funding has outstripped European growth (Chart 34), this growth has been insufficient to close the gap on the European averages and reflects very low starting point for private equity investments in Austria in the 1990s. Arguably, increasing European integration could have been expected to drive a catch up process for private equity as a source of financial capital in Austria. This has evidently not happened

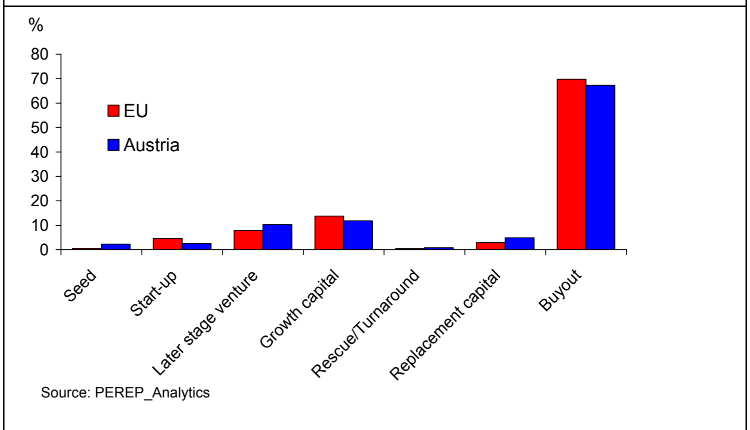
Chart 34: Trends in private equity investment 1998-2008



Source: PEREP_Analytics 2009

The spread of investments in Austria across the different categories of private equity matched closely the spread across Europe as a whole in 2008. A slightly bigger share of Austrian private equity investment was devoted to seed capital, later stage venture capital and growth capital, but less went to start-up capital and growth capital.

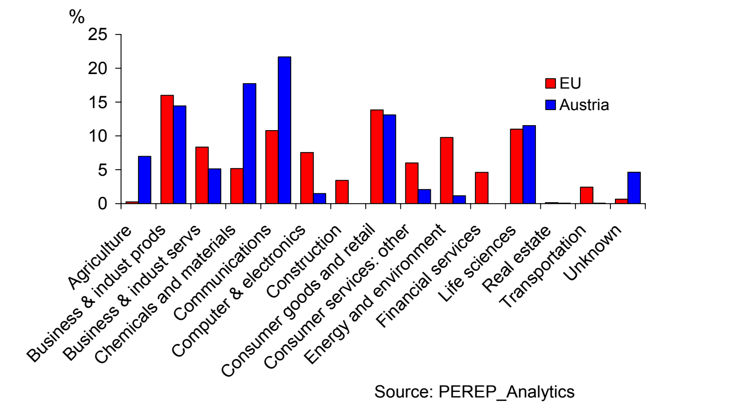
Chart 35: Share of private equity investment by type 2008



Source: PEREP_Analytics 2009

Chart 36 shows the distribution of private equity investments in Austria by industry in 2008. A much bigger share of Austrian private equity went to the agriculture, chemicals & materials and communications industries than was the norm for Europe. Lower shares devoted to the computer & consumer electronics, energy and environment, business & industrial services, other consumer services and financial services sectors balanced this.

Chart 36: Share of private equity investment by industry 2008



Source: PEREP_Analytics 2009

Buyout investments in Austria have tended to be small; indeed only in 2007 and 2008 were there deals that fell into the medium size category. While it is also true that the majority of buyout deals in Europe are classified as small, deals classified as large or mega have accounted for around 50% of the total funds invested.

Table 5: Distribution of buyout investments by size

	2006		2007		2008	
	Austria	Europe	Austria	Europe	Austria	Europe
Small	100%	10%	18%	10%	26%	11%
Mid-market	0%	37%	82%	43%	74%	46%
Large	0%	15%	0%	23%	0%	18%
Mega	0%	39%	0%	25%	0%	25%

Source: PEREP_Analytics 2009

6.1 Private equity – capital raising

Table 6 ranks the top ten private equity firms on the basis of capital raised in the last 5-years. No Austrian private equity firm appears in the top 300 global private equity firms ranked in this way.

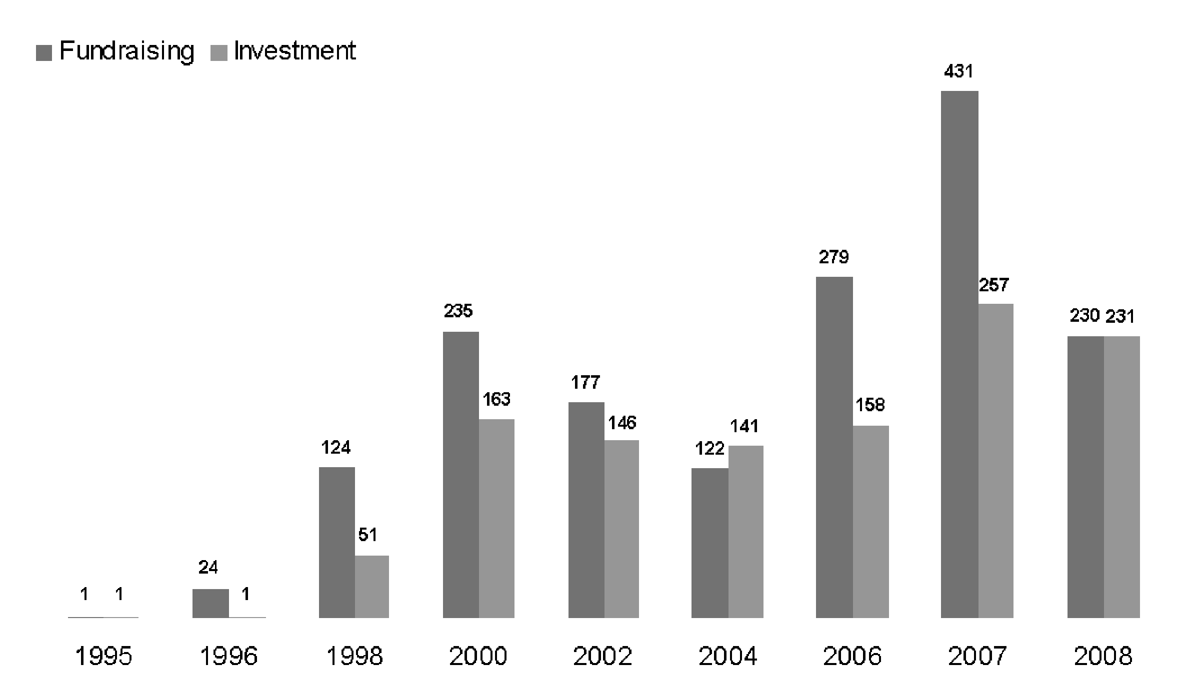
Table 6: Top ten private equity firms by cash raised

2009 Rank	Company	Location	Capital raised in last 5 years $bn
1	TPG	Fort Worth (Texas)	$52.3
2	Goldman Sachs Principal Investment Area	New York	$49.0
3	The Carlyle Group	Washington DC	$47.7
4	Kohlberg, Kravis, Roberts	New York	$40.4
5	Apollo Global Management	New York	$35.2
6	Bain Capital	Boston	$35.0
7	CVC Capital Partners	London	$33.7
8	The Blackstone Group	New York	$30.8
9	Warburg Pincus	New York	$23.1
10	Apax Partners	London	$21.3

Source: Private Equity International 2007

The beginning of Private equity fundraising only really took off in the beginning of 2000 and peaked in 2007. It slowed down significantly in 2008 following the impact of the global financial crises that hit global fundraising dramatically.

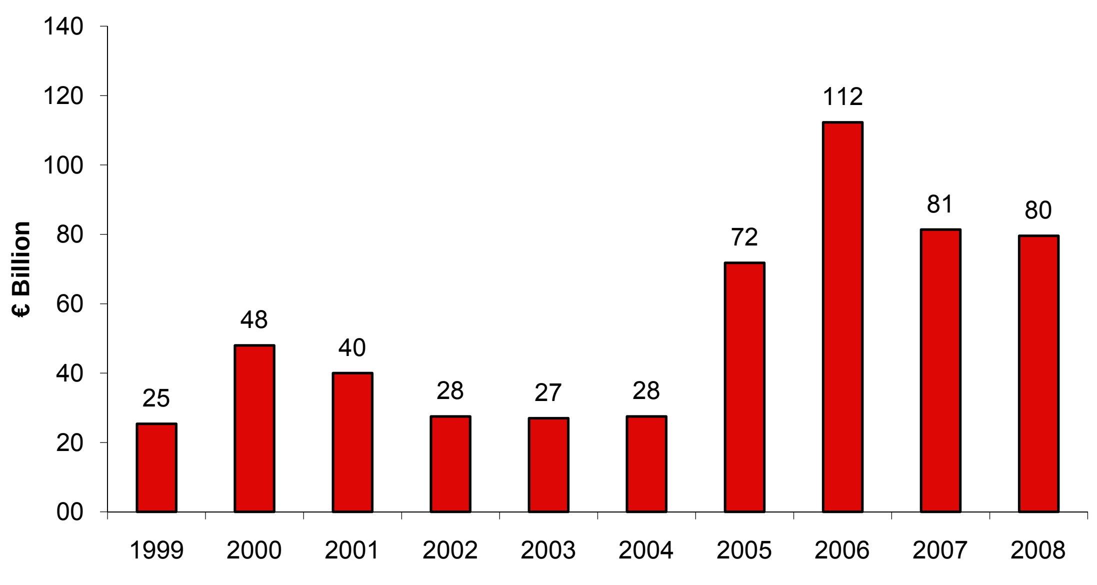
Chart 37: Private Equity Fundraising in Austria 1995-2008 (1000 €)



Quelle: EVCA/PEREP_Analytics 2009

Fundraising on European level dwarfs the activity level in Austria. However the same pattern in terms of increasing fundraising activity starting year 2000 is to be observed. Year 2002 following the brief global recession in 2001 (caused by the blast of the IT bobble) actually proportionally hit the European average more than Austria.

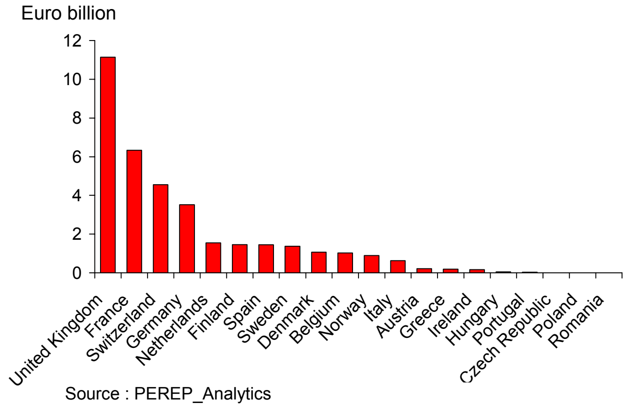
Chart 38: Evolution of European private equity funds raised – industry statistics



Quelle: EVCA yearbook 2009

As shown in Chart 42, in 2008 new private equity funds raised in Austria totalled under 0.3% of the European total for the year, positioning Austria thirteenth out of twenty European countries. The UK raised the most new private equity capital in 2008 (€11.1billion), followed by France (€6.3billion) and Switzerland (€4.5billion)

Chart 39: European private equity raising, 2008 (Euro millions)



Source: PEREP_Analytics 2009

One explanation besides the economic meltdown for the financial industry in general, and the subsequent impact on fundraising for private equity specifically, could also be the change or absent of the Banks as source of fund raising (see chart 40)

Chart 40: Source of Funds raised in Austria 2008

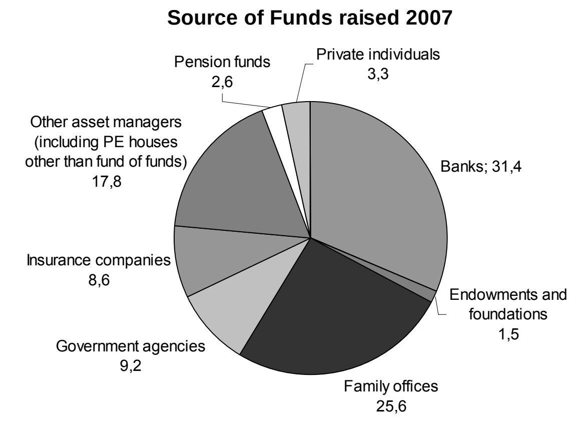
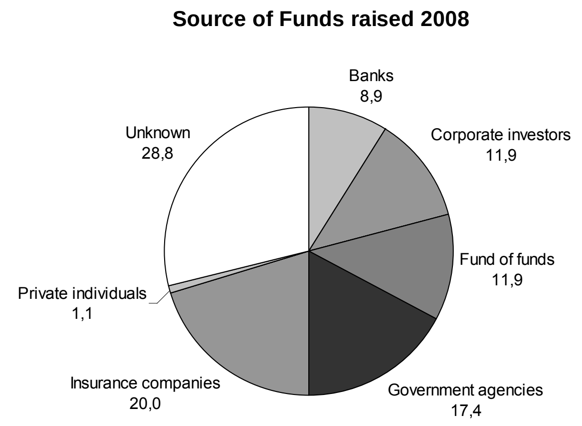


Chart 41: Source of Funds in Austria raised 2008

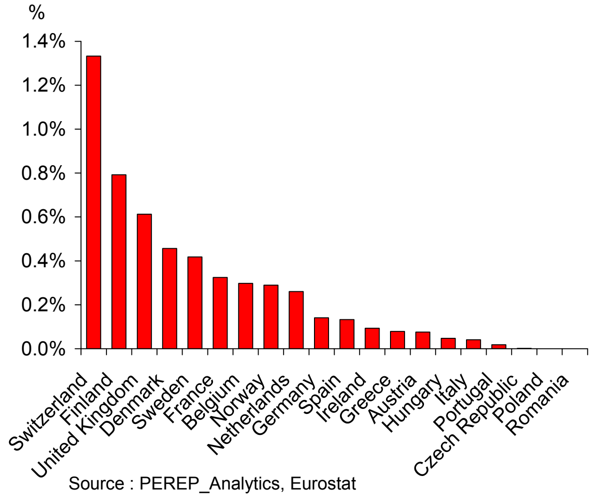


Source: AVCO/EVCA 2009

One observation, which significantly differs to other European and US sources of fundraising in Austria, is the absence of Pension funds as provider of capital to Austrian private equity industry players. The Banks has also been reluctant to allocate funds outside their own private equity vehicles. Most of the major Banks in Austria got involved in private equity with own legal entities following the same model as none financial private equity firms. This is not unusual and also seen in other European countries. There is no public information available on allocated funds from banks to firms outside their own vehicles. It is the inside opinion in the Austrian private equity industry, that Banks has tried to control competition by setting up their own vehicles, and have been very reluctant to allocate funds to outside players. In the UK the picture would look different. UK Banks has historically been big investors in both own and private equity industry players.

In relation to GDP Switzerland heads the European ranking with private equity funds raised in 2008 equivalent to 1.3% of GDP, followed by Finland and the UK with 0.8% and 0.6% respectively. For Austria the equivalent ratio was 0.08% (see Chart 42).

Chart 42: European private equity raising relative to GDP, 2008



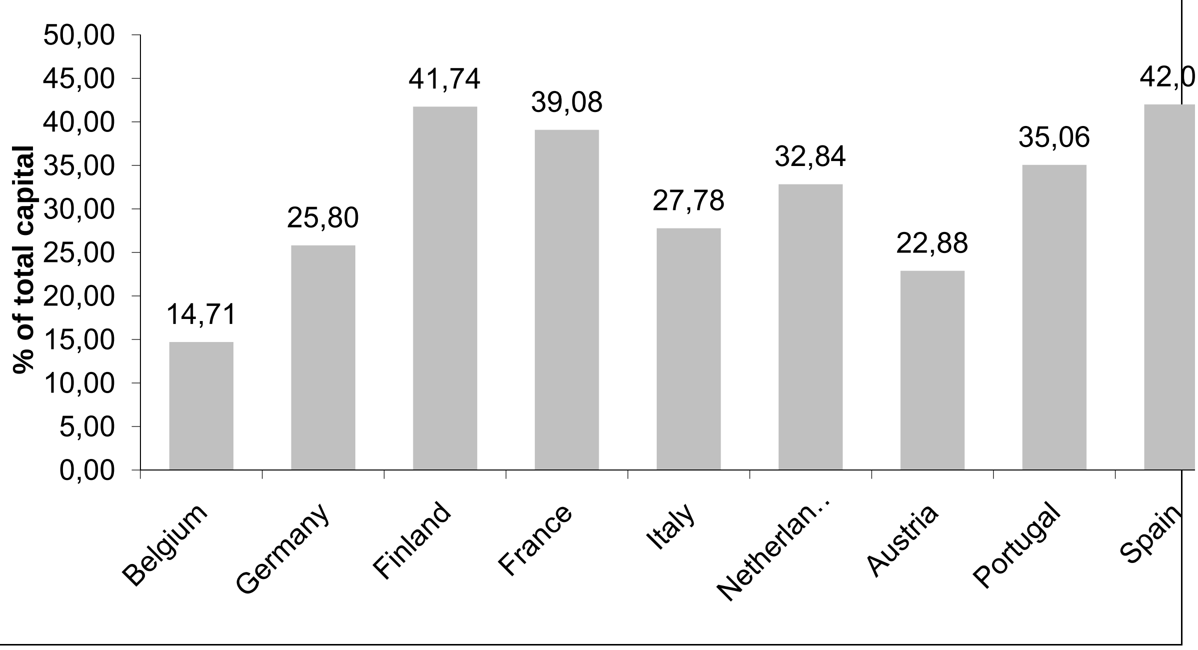
Source: PEREP_Analytics 2009

7.0 Other considerations

Since Austria's accession to the EU, in some ways the financing of Austrian businesses has moved to more closely resemble typical arrangements in the rest of Europe, with a much higher than average reliance on bank loans slowly diminishing. However, with respect to the use of equity finance Austria remains low, with a weak equity market culture. This might help to explain why Austria remains stuck at the bottom of the European league tables for the involvement of private equity and venture capital in financing of business.

The post-crisis banking environment may lead to greater difficulty in securing funding from the banks and even mean that existing arrangements come under pressure where businesses are suffering from the economic downturn and the banks are seeking to reduce their exposure to particular sectors or types of business. The low equity ratio of the Austrian SME sector (see chart 43) might just aggravate this situation and prohibit many business from getting loans at all, potentially hampering their growth opportunities or even leading into potential liquidation.

Chart 43: Equity ratio SME – Selected European benchmark



Source: Mittelstandsbericht 2006/07, Bundesministerium für Wirtschaft und Arbeit

Equally the small size of the Austrian quoted and unquoted equity markets may also mean that fund raising from these markets, which have been used successfully in Europe, by businesses seeking to replace debt finance with equity, may not be as readily available to Austrian businesses.

It would therefore appear that there remains considerable scope for the development of aspects of the capital market and sources of funding that will allow Austria to get the full benefits of increasing European integration. One aspect of this is the development of an environment in which private equity can play a bigger role in financing start-ups, growth businesses and turnaround situations. This aim is a priority for Europe as a whole. For example, ECB research "suggests that the development of significant private equity and venture capital markets would help to overcome difficulties in financing start-ups and other small innovative firms, which in turn would have beneficial effects on growth and productivity."[40] However, Austria starts from an even less favourable position than many other European economies.

The Global Venture Capital and Private Equity Country Attractiveness Index for 2009/10[41] scores Austria poorly on the depth of its capital market (Chart 44). This scoring is based on an assessment of:

- The size and liquidity of the stock market (45th out of 65 countries assessed)
- IPO market activity (27th)
- M&A market activity (35th)
- Debt and credit market (14th)
- Financial market sophistication. (16th).

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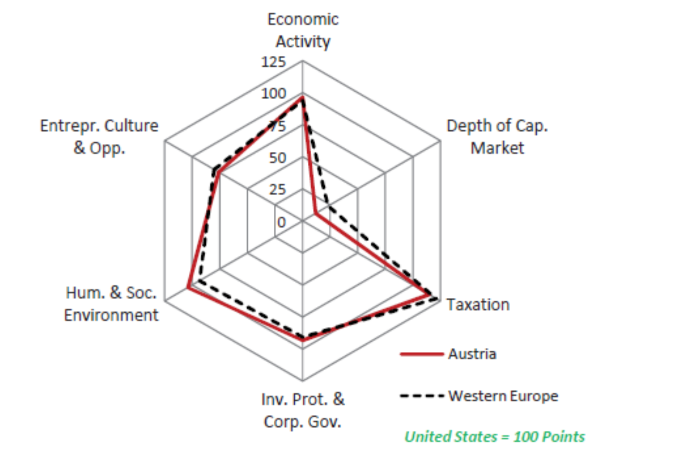
[40] Presentation by Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB, 2007 Washington Economic Policy Conference, http://www.ecb.int/press/key/date/2007/html/sp070312.en.html
[41] See http://vcpeindex.iese.us/

Chart 44: Austria private equity performance factors 2009/10



Source: Global Venture Capital and Private Equity Country Attractiveness Index for 2009/10

There may also be issues relating to investor protection that are holding back the development of deeper equity markets and private equity investment in Austria. For example the World Bank[42] ranks 183 countries annually according to the "ease of doing business". In the Doing Business 2010 report Austria is positioned 28th overall but scores particularly poorly on protecting investors[43] (132nd), starting a business[44] (122nd) and paying taxes (102nd)[45]. Areas of strength are assessed as enforcing contracts (11th), getting credit (15th) and closing a business (20th).

The theme of investor protection, the depth of the equity market and the related role of venture capital has also been highlighted in work undertaken by researchers at the Austrian central bank. The abstract to the paper "The Financial System and the Institutional Environment as Determinants of Economic Performance: Austria in Comparison"[46], summarises the issues facing the Austrian market as:

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[42] See http://www.doingbusiness.org/EconomyRankings/
[43] Based on strength of investor protection index: extent of disclosure index, extent of director liability index and ease of shareholder suits index.
[44] Procedures, time, cost and paid-in minimum capital to open a new business.
[45] Number of tax payments, time to prepare and file tax returns and to pay taxes, total taxes as a share of profit before all taxes borne.
[46] The Financial System and the Institutional Environment as Determinants of Economic Performance: Austria in Comparison, Friedrich Fritzer. ONB, Monetary Policy & the Economy Q1/06

“Compared with the U.S.A. or the United Kingdom, the ownership structure of listed companies is highly concentrated in Austria and in many other euro area countries. In fact, the Austrian stock market stands out in terms of its high ownership concentration. However, empirical evidence indicates that an all too high level of ownership concentration has a negative impact on firm performance. Fostering investor protection is a natural lever to promote a higher degree of dispersion and hence a lower level of concentration. Although the standards of investor protection in Austria have improved substantially in recent years, they still need to be safeguarded and strengthened where necessary.

Another important issue in this context is the development of venture capital markets which are key to innovation and hence to productivity. It is no coincidence that the most liquid venture capital markets are found in countries with the most developed stock exchanges — e.g. the U.S.A., the United Kingdom and the Netherlands. The Austrian venture capital market is one of the smallest by international standards. In order to promote venture capital in Austria, the local stock market, which provides exit opportunities for venture capitalists, needs to be deepened.”

8.0 Issues

The medium-term evolution of the Austrian capital market and the impact of the global financial crisis both throw up issues for the future shape of financial capital of Austrian businesses. These include:

- The degree to which Austrian banks are now constrained in their lending activity by worries over their capital position and exposure to bad loans, including those to companies in Eastern Europe?
- The extent to which growth and entrepreneurship in Austria is disadvantaged by a weak equity culture
- The extent to which investor protection concerns remain a hindrance to the continuing development of quoted, unquoted and private equity investments in Austria?
- The extent to which private equity can provide an alternative and more attractive form of capital for businesses?
- Whether the low penetration of private equity and venture capital in Austria is driven by demand side factors, particularly in the wake of the financial crisis, or by aspects of the supply of this type of capital in Austria?

9.0 Conclusion

The global private equity has grown to a Trillion dollar industry spanning all corners of the world. It accounted for almost 40 percent of all global M&A activity pre-crises. It has attracted some of the best and brightest people and managers across all industries. Its reputation has been tarnished from spectacular deals in the 80 and 90´s only to see it gaining more public accomplishment in the new millennium. However the public has come to learn that this industry needs more transparency and regulation. But the public has also recognised that private equity is a key provider of risk capital in the form of equity, and that most of the serious players actually contribute to public wealth creation, perhaps not as much as desired over the tax bill, but from growing and nursing business to pursue their true potential.

When will Austria finally come to learn that this industry is a key part of a good financial market? Well that is not easy to answer, and many historical facets play it parts, like the absence of an equity culture and the reluctance to give up ownership. But it is encouraging to see that between 2006-2007 money was flowing into the private equity industry. It remains to be seen if this was a short-lived upturn, or if the industry will continue to develop post the global recession.

A number of factors are playing in the favour of the Austrian private equity. For one private owned firms are having trouble finding credit. This is partly due to their low equity ratio and the crises in the Austrian Banking sector. The historic dependence on banks as capital provider for Austrian firms might rapidly change, when the company owner or CEO find himself disappointed with the action of his bank. He might also get a lesson learned that equity is important to sustain growth, and one way to get equity is to open up for ownership in his business.

It’s a statistical fact that the majority of Austrian non-listed firms are facing huge generational change issues over the coming decade. Many family owned businesses simply couldn’t make a generational change because there are no family or capabilities to take over. This could be the big chance to private equity players in helping out solving this issue. The company owner might even realise that private equity is not just out to take his business and cash in, but could even be providing flexible terms for him to partly cash out, and still retain a role in his business. Many options are open in this respect, and many equity funds are more than happy to structure deals with the needed flexibility.

The historic dominance of the Austrian Banks might finally change colour as Austria develops its international expansion. The fact that a few Banks, or actually one big bank can dominate the Austrian capital market and its business industry so much is highly unusual in a western democracy. Eventually companies and the public might come to realise that diversification and break up of monopolies are for the good of society.

With less concentration of financial players, we might finally start seeing the financial industry supporting the private equity industry on the fund side. The big discussion in the US, triggered by the financial meltdown of some of the big Wall Street Banks, might even lead to new legislation which will prohibit Banks to have their own private equity business. If this legislation passes, which there seem to be a good chance of doing, this will undoubly spread to Europe. Austria in my mind, provided that the same legislation is passed in this country, might hugely benefit from this separation. Let the banks do what they are best at, lending money out, let someone else run companies. The Banks, the owners of the SME´s all need alternative equity providers to keep the wheels running. Society need risk capital to help grow the businesses and ensure innovations of tomorrow. Private equity and venture capital should be playing their role and find itself to be an important and respected pillar in a well functioned and well developed Austrian capital market.

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11.0 Appendix A

Total funds raised 2007/08

Amount in € millions	2007 Amount	2008 Amount	Change %
United Kingdom	43,808	46,452	6.0
France	6,551	10,778	64.5
Sweden	4,686	6,612	14.1
Switzerland	1,478	3,081	41.1
Germany	5,662	2,410	-57.4
Spain	3,298	2,224	-32.6
Netherlands	3,141	1,586	-49.5
Italy	2,408	1,455	-39.6
Norway	703	1,282	82.3
Finland	1,015	903	-11.0
Poland	571	760	33.3
Belgium	598	608	1.6
Denmark	361	258	-28.5
Austria	431	230	-46.6
Ireland	466	155	-66.7
Hungary	0	120	-
Greece	5,570	20	-99.6
Czech Republic	78	19	-75.7
Portugal	496	15	-96.9
Romania	36	0	-100.0
European total	81,357	78,968	-2.9

Source: EVCA yearbook 2009

12.0 Appendix B

The Basic Value Creation Formula – An Example: Carlyle Group

Leveraged Buyout

Annual Profits		10,000,000
Price Paid	10x	100,000,000
LBO	Equity	30,000,000
	Debt	70,000,000

Case 1 (5 years) – No Profit Increase

Annual Profits	10,000,000
Debt Paydown	30,000,000
Exit (10x)	100,000,000
Remaining Debt	40,000,000
Net Proceeds	60,000,000
Original Investment	30,000,000
ROI	100%
Annualized	15%

Case 2 (5 years) – Profit Increase

Annual Profits	15,000,000
Debt Paydown	0
Exit (10x)	150,000,000
Remaining Debt	70,000,000
Net Proceeds	80,000,000
Original Investment	30,000,000
ROI	167%
Annualized	22%

The above example demonstrate in a case example taken from Carlyle Private equity Group, that from the investor point of view the name of the game is to drive growth rather than paying down debt. The ROI that he can show his sponsors are significantly positively supported by the debt leverage. This is because IRR as mentioned in the paper is not measuring the cost of capital!