



# Branching out

How do private equity investors create value?  
A study of European exits





# Contents

1	Foreword
2	Executive summary
4	Key findings
12	Outlook
14	About the study
16	Contacts

# Foreword

The Ernst & Young series of studies, “How do private equity investors create value?”, go to the heart of the way in which private equity investors drive sustainable improvements to the businesses they back, generating not only financial, but also social returns. We at the European Private Equity and Venture Capital Association are delighted to support this, the seventh study, which provides further proof of the industry’s enduring positive impact on Europe’s economy.

Part of our mission at European Private Equity and Venture Capital Association is to promote a better understanding of the industry. Independent, empirical research helps us achieve this. Such studies are vital at a time when public debate is increasingly challenging the industry to prove its case.

By lifting the lid on the way that private equity operates, this study proves that, contrary to public opinion, the industry generates the majority of returns for its investors through creating lasting value rather than leverage. Debt is not driving private equity’s success. Instead, it is the industry’s ability to spot potential in different markets then partner with management to improve strategy, operations and efficiency, while providing the capital necessary for growth in new markets that is central to the industry’s record for generating strong returns.

Private equity’s focus on value creation has shone through in each of the studies compiled in the series. Now in its seventh year, the longevity of the data in this study clearly validates the facts: private equity supports the companies it backs through time and the good and bad periods of economic cycles. The model also builds more productive businesses but not, as the industry’s critics would have it, at the expense of employees, as the study shows.

This study adds to the body of evidence that private equity plays a positive role in European society. Not only does it generate good returns for Europe’s increasing numbers of pensioners and savers, its investment model is creating stronger, more competitive companies. In addition, private equity provides much-needed capital to help Europe’s companies expand at a time when banks are deleveraging and other sources of financing are constrained. European leaders see economic growth as the path to a brighter future for the region. Private equity will play its part in delivering that growth.

**Dörte Höppner**

Secretary General

European Private Equity and Venture Capital Association

# Executive summary

This is the latest of our annual studies looking at if and how private equity (PE) investors create value. Since we started this project in 2005, we have used a consistent set of criteria to select our study group: European-based businesses owned by PE, with enterprise value (EV) of more than €150m at the time of PE investment, or “entry”. Each year, we research the latest exits by PE houses from this group to analyze the performance of businesses during PE ownership, on the basis of the financial returns from the original investment. Through our analysis, we seek to understand and explain if and how PE adds value to the businesses it backs.

This is our seventh study and it is set in a time of continued macroeconomic uncertainty across Europe. The sovereign debt crisis has cast a long shadow across the region's economies and companies. Yet despite that, 2011 saw exit numbers improve significantly as PE owners seized opportunities to realize investments. Exits rose to 83, the highest number recorded since the peak years of 2007 and 2006. Most notably, trade buyers, who had been noticeably absent in recent years, returned in 2011 – and accounted for most of the growth in realization volumes.

Over the last seven years, our research has shown that 87% of realized investments generated a positive return for investors, and in 2011 this figure was 90%. Our analysis also shows that the gross return on these PE investments outperformed investments in comparable public companies by a factor of 3.6 times.

Proactive strategies employed by PE owners to build the value of their businesses (PE value creation) rather than additional leverage, accounts for the majority of this outperformance. Part of the PE value creation came from driving business improvements in its portfolio companies, evidenced by strong productivity growth. It also came from carefully selecting, and backing, the businesses and management teams that had the greatest potential to produce a step change in value.

The industry has weathered the economic storm and attention has now turned to new investments and fund-raising. In this year's study, we analyzed PE's realized investments across different markets in Europe, to determine whether its track record across different deal sizes, types, geographies and sectors, might help to guide future investment.

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# 83

Total number of exits in 2011, the highest recorded since the peak years of 2007 and 2006.





The simple finding is that the PE model works across all the different markets and deal types in our analysis, with returns well in excess of those achieved by comparable public companies.

Our study shows that the PE model works across all deal sizes, with those between €150m and €500m in entry EV showing higher PE value creation (or PE strategic and operational improvement) than larger deals. In our geographic analysis, we demonstrate that PE has adapted to the different markets across Europe, with the UK and Ireland, France and the Germany – Switzerland – Austria (GSA) region emerging as particularly strong markets in terms of productivity growth. Looking forward, the French and GSA PE markets also show potential for high growth given that their PE penetration rates are low relative to other regions, such as the UK and the US.

By industry sector, business services, retail and health care emerge from our study as the best performing and largest sectors for PE. By contrast, capital- and consumer-led sectors, such as personal and household goods, have seen below-average performance and growth – in line with lower returns from public companies in the sector.

The overall picture that emerges from our study is one of improving health for PE as exit activity grows, creditor exits fall, and PE investments continue to deliver outperformance relative to public markets. And, while the patterns of returns, outperformance and productivity growth have varied across different markets analyzed in this report, the overall conclusion is that the PE model has had widespread success. Selecting investments and driving business improvements have been key to successful PE investment. If they are to continue generating high returns at a time of low economic growth across the region, PE firms will need to hone these skills further.

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# 87%

Percentage of realized investments over the last seven years that have generated a positive return for investors.

# Key findings

## 2011 exits: volumes are increasing

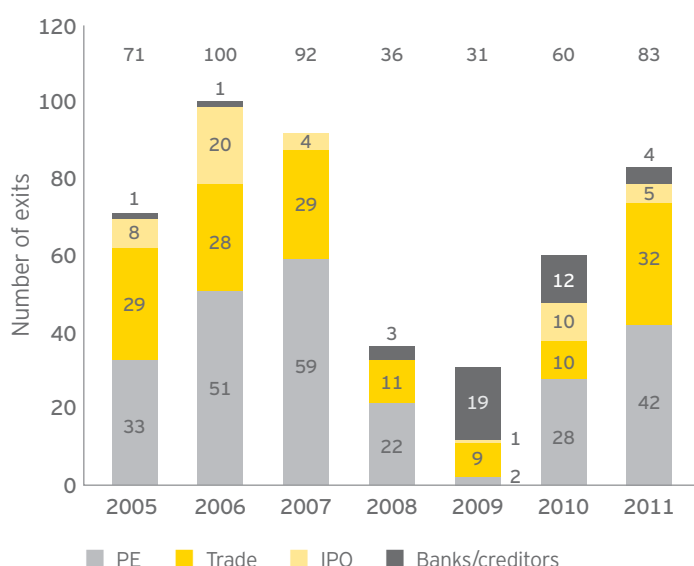
Our 2011 study shows that the European exit environment continued to improve, following a pick-up in 2010. Last year, there were 83 exits of PE-owned businesses that met our criteria for inclusion, the highest since 2007, before the financial crisis erupted. PE achieved these volumes despite the macroeconomic uncertainty that played out in the second half of the year as the sovereign debt crisis worsened.

Driving this increase in activity was the long-awaited return of trade buyers – a highly positive development. In last year's report, we noted that only when trade buyers returned would we see a normalization of the exit market. This reawakening of trade interest in PE portfolios may be the start of this process as corporates increasingly seek new areas for growth and turn to M&A as an effective means of investing the considerable amounts of cash on their balance sheets.

Accounting for 39% of 2011 exits, trade buyers made their strongest showing since 2005, when they made up 41% of buyers from PE portfolios. After sitting on the sidelines for a number of years, corporates now appear more willing to deploy their cash reserves to buy companies where they see opportunity to grow in new markets and to acquire know-how or technology. The rise in trade buyers suggests they see sustainable value in European PE-backed businesses.

However, the exits in our sample demonstrate that this renewed confidence in acquisitions is far from evenly distributed. While European strategic buyers still accounted for the highest proportion of trade buyers by region in 2011 (44%), this is much lower than the average of 76% in 2005-2007. By contrast, US and Asia-Pacific buyers were much more active in 2011, making up 31% and 19%, respectively, of trade buyers of PE businesses. These proportions are both about double the average in the 2005-2007 period.

**Figure 1.**  
PE exits 2005-2011, by exit route



Source: Ernst & Young data

# 50%

Percentage of trade buyers of European PE assets from Asia Pacific and the US.



# 3.6x

Level of outperformance by  
PE-backed businesses compared  
to the public markets, 2005-2011.

After a strong showing in 2010, the volume of exits via IPO was subdued last year. There were only five listings (6% of the total exits) from the sample in 2011, attesting to the uncertainty that prevailed in the public markets, particularly in the second half of the year.

On a more positive note, creditor exits continued to decline. There were just four in the sample in 2011, although by value the fall from 2010 was less significant. This downward trend may reflect PE's focus on strengthening portfolio companies, and its efforts to refinance debt over the last few years, leaving the portfolio companies more resilient in times of turbulence.

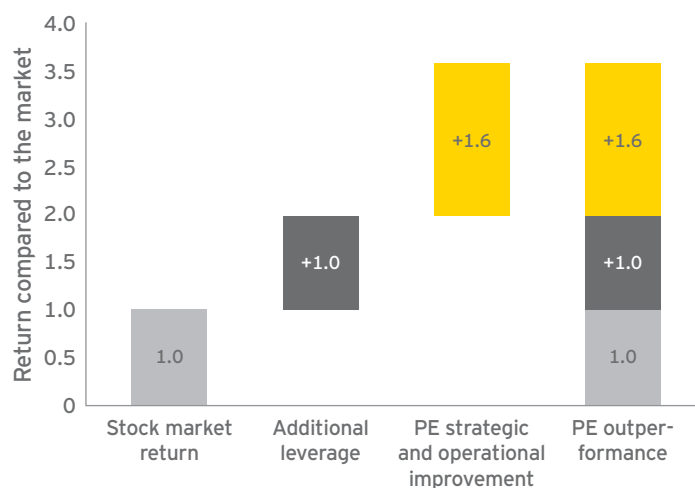
## PE still outperforming public markets

Our analysis shows that businesses owned and exited by PE have continued to outperform comparable public companies (all listed businesses in the same sector and country and over the same timeframe as the PE-backed companies). This is despite the difficult economic conditions experienced over the last few years, the impact of creditor exits, and a corresponding decline in total investment return.

For the years 2005-2011, our study found the level of outperformance of PE investments was a factor of 3.6. Of this outperformance, PE's strategic and operational improvements – or value creation – provide the largest component of returns over the whole 2005-2011 exit sample.

Our analysis (discussed later in the report) shows that PE achieved this by improving portfolio companies' long-term prospects and value under their period of ownership, by growing profitability, productivity and employment. The benefit of PE value creation is 1.6x the return from public markets, and far higher than the effect of additional leverage (i.e., the amount of debt in a PE-backed company in excess of public company benchmarks), which provided a 1x return over public markets. Our findings run counter to the popular perception that PE generates its returns mainly through leverage.

**Figure 2.**  
PE returns compared to the public market, 2005-2011



N = 307 (excludes deals for which insufficient data are available to calculate returns)  
Source: Ernst & Young data, DataStream

# Key findings continued

## PE outperforms across all deal sizes

In previous years, we examined how PE ownership has generated outperformance. Last year's report found that EBITDA growth and, in particular, organic revenue growth, was the main driver of returns. This year, we sought to determine where PE has generated the highest returns, analyzing performance by investment size, region and sector.

Our analysis demonstrates that the PE model adds value across all deal sizes. Each deal size category saw positive investment returns, with the absolute level of return decreasing with deal size.

There are variations between sources of investment return across the different deal size ranges. However, our findings show that across the spectrum, PE value creation is one of the most – if not the most important – driver of returns.

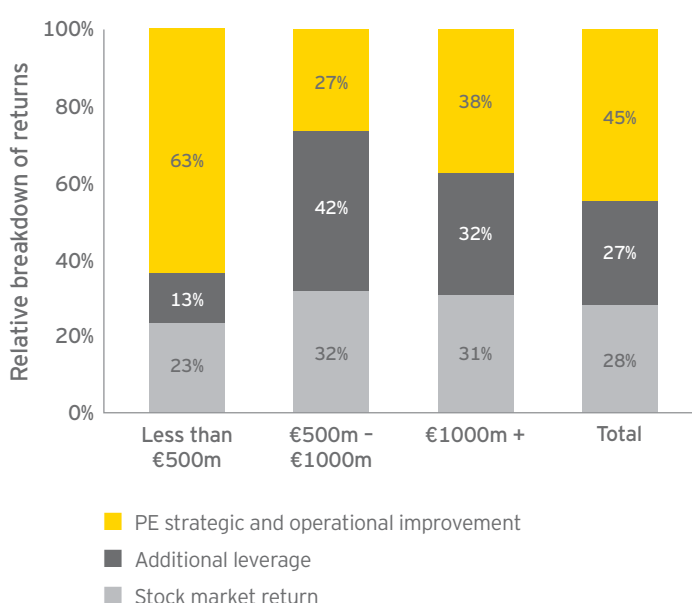
For the largest investments (greater than €1b entry EV), the public market return accounts for 31% of the total return, with the effect of additional leverage representing a similar amount, and PE value creation accounting for 38% of the total. Put another way, these investments achieved just over three times the stock market return – a significant outperformance.

PE strategic and operational improvements provide the highest proportion of returns in the smallest deals in our sample (between €150m and €500m entry EV), accounting for almost two-thirds of returns in this segment of the market. This is consistent with faster levels of profit, productivity and employment growth compared to larger-size deals. The leverage effect here made up less than 15% of returns.

Our analysis last year showed that investments sourced from PE portfolios (secondary buy-outs) performed at least as well as investments bought from corporate sellers or take-privates of public companies. However, the debate around PE's ability to generate value in secondary buy-outs continues. With just over 50% of exits in 2011 being by sales to PE and a large stock of

**Figure 3.**

Returns from PE relative to the stock markets, by entry EV range, 2005-2011



N = 307 (excludes deals for which insufficient data are available to calculate returns)

Source: Ernst & Young data, DataStream

portfolio companies still to exit, this type of deal will continue to feature heavily in future PE performance. Our analysis shows that, to date, secondary buy-outs have performed well under new PE owners, delivering a gross return of 4x the equivalent stock market return. This comprises an equal mix of PE value creation and additional leverage, each at 1.5x the stock market return. It shows that PE firms are successfully selecting secondary buyout deals where they see opportunity for further growth and value creation.





**45%**

Percentage of returns attributed to PE strategic and operational improvements.

# Key findings continued

## PE drives productivity gains and employment across Europe

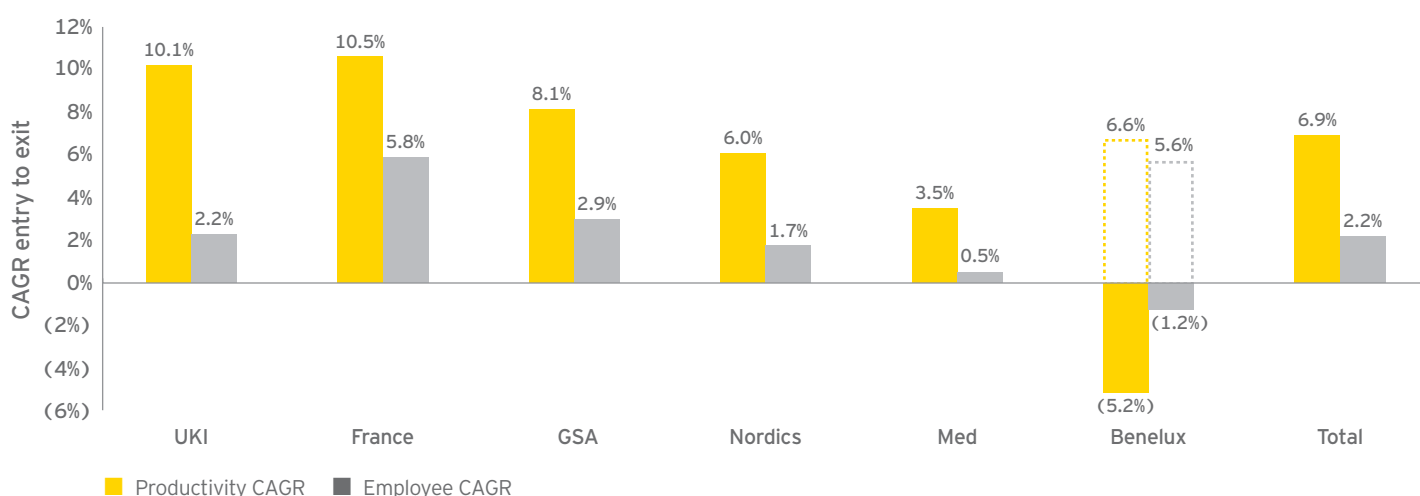
This year's study reveals that PE's value creation model works across Europe's different markets. In all the countries we analyzed, the investment return is at least 2.5x the comparable public company return (versus the 3.6x average as above). The only exception is the Nordics, where the absolute return equals the average across all countries. A much higher public company return in the Nordics than in other countries reduced the effects of both the additional leverage and PE value creation.

Behind PE outperformance and PE value creation, productivity (as measured by EBITDA per employee) and employment are key drivers of business performance and broader stakeholder interest

in PE. Our analysis demonstrates that PE has been able to improve productivity significantly (6.9% on average per annum across all European markets). It has therefore created more valuable, fitter European businesses while also increasing employee numbers – employment grew by an average of 2.2% per annum under PE ownership.

The fact that our study measures PE's record across exited businesses points to the long-term nature of PE's improvements. Buyers saw a sustainable rate of productivity growth and value in the exited companies. It is also worth noting that this analysis includes the full mix of PE investment strategies – from turnarounds to growth stories, all of which will have different productivity and employment profiles as a result of PE ownership.

**Figure 4.**  
Productivity and employment growth for PE-backed companies, 2005-2011



Dotted lines for Benelux show productivity and employment growth without outliers. N=178 (excludes deals for which insufficient data are available)

Source: Ernst & Young data, DataStream





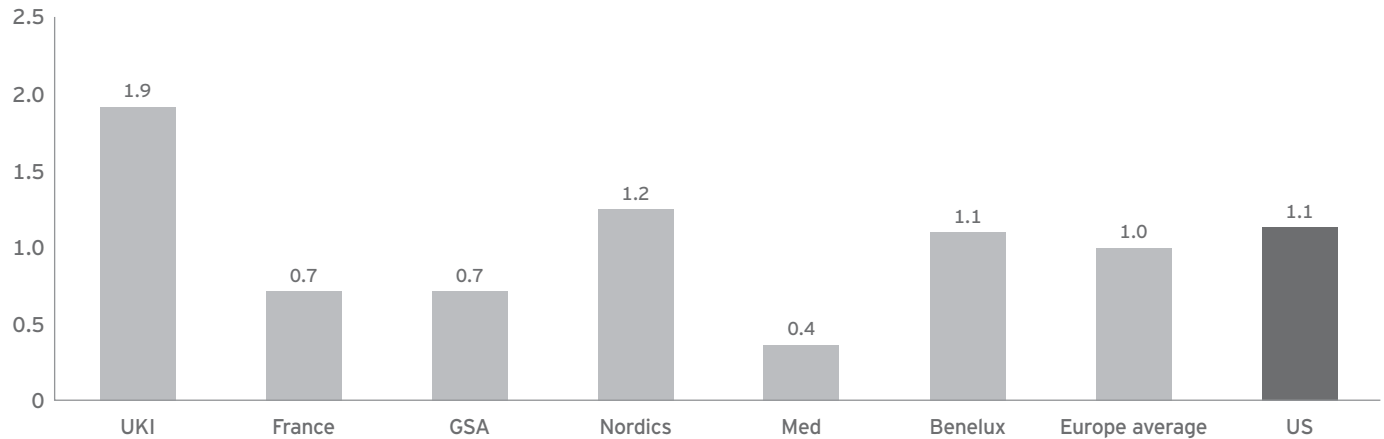
We also see a variation in performance across the different geographies. Figure 4 shows countries and regions appearing in descending order by the number of exits in our sample between 2005 and 2011. Thus, the UK and Ireland had the highest number of realizations and Mediterranean countries the lowest. France and UK and Ireland saw the greatest productivity gains, both registering improvements of over 10% compound annual growth rate (CAGR). GSA followed closely behind with a productivity CAGR of 8.1%.

These three markets also had the largest employment gains, with France showing the highest CAGR at 5.8%. PE-backed companies in the GSA region saw the second highest employment CAGR at 2.9%. Indeed, France and GSA in particular emerge as strong markets for PE value creation as our analysis also shows that PE value creation is greatest in their returns attribution profile.

The negative employment and productivity growth our analysis found in the Benelux countries was the result of large individual transactions. Once these were stripped out, the region showed positive productivity CAGR of 6.6% and a strong record on employment CAGR, at 5.6%.

In addition to their position as two of the strongest markets for value creation, France and GSA also have the greatest potential for future growth, along with the Mediterranean region. In our analysis of PE's penetration in each market (using an index derived from the 2011 ratio of PE-owned businesses' EV in our sample to GDP), the UK & Ireland emerge as Europe's most penetrated market with an index of 1.9, significantly higher than the European average of 1.0. The large and historically attractive markets of Germany and France have penetration measures of 0.7, indicating plenty of potential growth. For comparison, the US index currently stands at 1.1, based on our analysis.

**Figure 5.**  
PE penetration by region (2011 ratio of PE-backed businesses' EV in our sample to by GDP)



Source: Ernst & Young data, Global Insight.



# Key findings continued

## Business services, health care and retail emerge as strong performers

As we have demonstrated in previous studies, picking the right markets to invest in is a key skill for PE success. Across Europe, we find that PE firms are increasingly organizing themselves by industry sector in order to harness experience, focus origination activities and develop in-house expertise. Our prior studies have shown that this strategy is well-founded as a sector focus often generates better returns than a generalist approach.

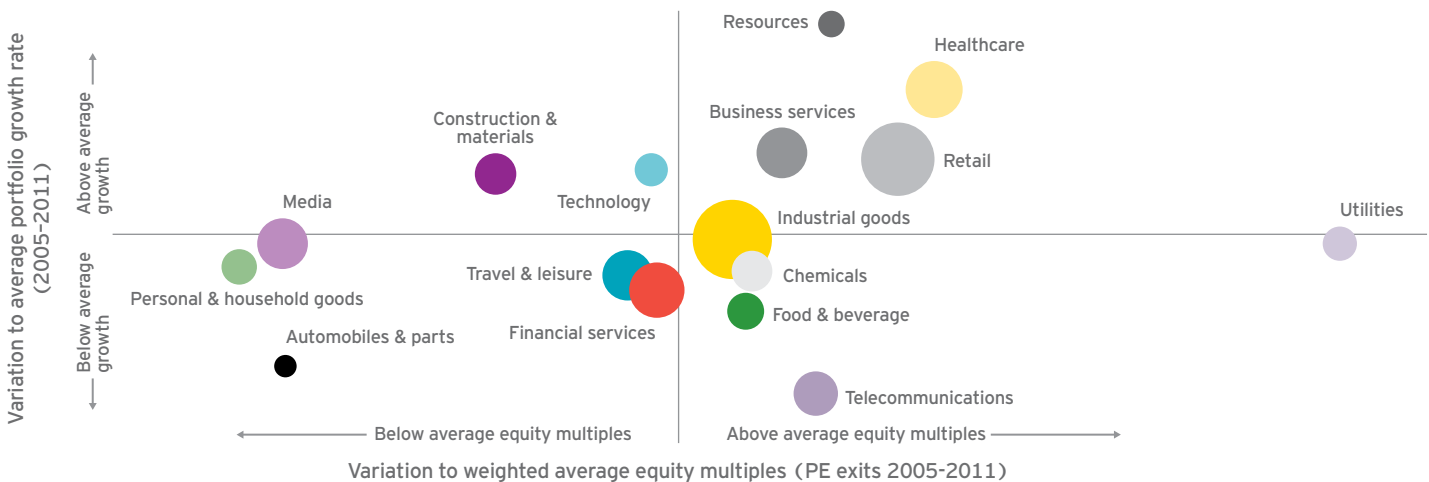
Our analysis of returns from exits, and growth in the portfolio in the 2005-2011 period, shows some variations by industry sector. Part of this reflects macroeconomic trends – particularly in the below-average return sectors – and in other cases it reflects specific growth opportunities that PE investors are targeting.

Our analysis shows that business services, retail and health care are some of PE's best performing sectors. All three have delivered above-average returns and above-average portfolio growth (portfolio growth is defined as the growth in the entry EV of the stock of investments in that sector between 2005 and 2011).

Business services has been a particularly successful sector for PE. It has grown strongly and delivered above-average returns. Deals in this sector are typically smaller than average and the portfolio has a high concentration in the UK, with very few creditor exits.

Among the larger sectors, portfolio growth has been highest in health care. This reflects the attractions of the health care sector as the effect of an aging population in Europe plays out, along with its largely non-cyclical nature and the prospects for further growth of the private sector in many parts of Europe. Its strong

**Figure 6.**  
Relative returns and portfolio growth by sector, 2005-2011



Size of the bubble represents the relative portfolio size in 2011.

N= 319.

Source: Ernst & Young data.



growth and above-average returns are in part influenced by a few large deals – most of the rest of the deals in this sector have been at the smaller end, with opportunities emerging from private, corporate and PE sellers.

Retail is the second largest sector in the portfolio, with growth driven mainly by large transactions completed before the credit crunch. The incidence of creditor exits is low in this sector – one of the contributing factors to the sector's above-average performance. However, exit activity is below average.

Below-average performers have largely been capital- and consumer-led sectors, such as automobiles and parts, personal and household goods and media. PE's performance in personal and household goods and media is mirrored by that of public company comparables, which have also generated below-average returns. At a macro level, the personal and household goods sector has faced several challenges: pressure on consumer spending, competition from Eastern imports and high input costs as commodity prices have soared. It has also seen a high incidence of creditor exits. The media sector's below average performance is also the result of a number of factors, including the impact of the internet on many of the more traditional media business models and a small number of very large investments exiting to creditors.

Our analysis shows important differences emerging among different sectors. However, specific factors related to a particular investment, such as a PE firm's ability to select the right business to back, to create value during ownership and sell well, also play a significant role in determining the success of an investment.

# Outlook

In 2011, as in 2010, it became evident that PE had weathered with resilience what has been a prolonged and unpredictable economic storm. Our more recent studies have shown that, notwithstanding the challenging environment, PE is continuing to provide returns to investors through driving fundamental changes to the businesses it backs that improve productivity and create sustainable value.

The PE industry continues to face increasing regulation, as well as negative attention in some political and public circles. Yet our study demonstrates that much of the criticism leveled at the industry is misplaced. PE has shown itself able to create businesses that are fit for the future in what is an increasingly competitive global landscape. Productivity improvements in PE-backed companies are helping to bolster Europe's ability to compete commercially on a world stage, while also generating new employment and investment opportunities.

However, despite the industry's tenacity and agility, it would have been impossible for PE to escape the effects of the economic storm entirely. Every corner of the economy has been affected by the downturn, and returns on PE exits have also declined in recent years. The effects of buying businesses in a frothy market in the boom years, together with a slow economic recovery in Europe, are now apparent in PE's performance record. This downward trend may reverse, but it will take time to do so.

Our study demonstrates that much of the criticism levelled at the industry is misplaced.

The increase in 2011 exits is clearly positive for PE, particularly as the year saw a high level of activity from trade buyers. So far in 2012, the exit market looks similarly encouraging, with trade buyers, particularly those outside Europe, continuing to acquire from PE portfolios. PE needs to take the opportunity of increased overseas interest, largely from US and Asia-Pacific buyers, to increase its exit pace still further. Yet there are still question marks about the trade buyers that have historically accounted for most of the PE exits – European companies. As long as the European macroeconomic picture remains uncertain, it looks likely that these buyers will continue their cautious stance on M&A in the region. For the time being at least, getting European trade buyers to the table will be challenging.





Meanwhile, exits to PE, which made a strong showing in 2011, will continue apace. The amount of dry powder at firms' disposal, although lower than in 2010, remains substantial. PE will continue to seek out high quality, well-managed companies with good growth prospects from the European PE portfolio. The availability of leverage for these transactions has been, and will continue to be, dependent on the quality of the business being acquired and lenders' perception of risk in its market sector.

For their part, LPs remain willing to back funds that have not only generated strong performance in the past, but that can also demonstrate a sustainable investment strategy for the future – in what will be a very different environment from the one we have seen during the last decade. As a result, European PE funds will still be able to raise capital notwithstanding a challenging fundraising market. However, this capital will be concentrated among fewer groups that LPs consider to be tomorrow's stellar performers. Track record, added-value, sector and market focus and quality of team will be these firms' defining characteristics.

To continue to generate attractive returns, PE firms must seek out the investments with the most potential and then work actively with those companies to achieve that potential. Detailed research and origination have always been key elements of PE's success; these are becoming increasingly important in a more competitive and sophisticated deal environment. Our analysis has unearthed the segments, sectors and countries that have yielded the best results for PE. The real skill comes from choosing the right niches and individual investment opportunities within each – and making them work. Firms that can evolve by learning from the lessons of the past, harnessing experience and identifying future opportunities in a constantly changing world are most likely to succeed.

# About the study

The 2011 study provides insights into the performance and methods of PE, based on the analysis of the largest European businesses that PE has exited over the last seven years. The owners of these businesses were not all European-based themselves; this is not a study of the performance of European-based PE investors, but is rather an analysis of the impact of PE on European businesses.

To avoid performance bias, and to ensure a focus on the largest businesses owned by PE, exits were screened to capture only those that had an EV at entry of more than €150m. This criterion was also applied to our estimate of the current size of the PE portfolio. In total, we have identified 473 exits of businesses that met our criteria over the seven years from 2005 through 2011 – the “sample”.

We assessed business performance for the duration of PE ownership – i.e., from entry to exit – based on key performance measures, including change in EV, profit (defined throughout this report as earnings before interest, tax, depreciation and amortization, or EBITDA), employment, productivity (defined as EBITDA divided by number of employees) and valuation multiple. To better measure aggregate economic impact, we used weighted averages.

This independent study is built with public data across the whole sample and detailed, confidential interviews with former PE owners of these businesses. Overall, we have performance data for up to 319 businesses or 67% of the total population. Looking across key performance dimensions (e.g., deal size, exit route, incidence of creditor exits), there is no discernible bias in the composition of the sample compared with the whole population. For some of the performance metrics, our sample size is smaller than 319, and there is no significant bias compared to the whole population as measured by EV growth.

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# 473

Number of businesses that met our criteria over the seven years from 2005 through 2011.



### EV growth for the different sub-samples in this study

Performance measure	Sample size	EV growth
Relative returns and portfolio growth by sector, 2005-2011	319	14.5%
PE returns compared to the market; Returns from PE relative to stock markets, by entry EV range	307	14.6%
Productivity and employment growth for PE-backed companies	178	12.6%

### Number of exits in population and sample, by region

	UKI	France	GSA	Nordics	Med	Benelux	Total
Number of exits in population, 2005-2011	149	88	92	56	49	39	473
Coverage (sample as a % of population)	78%	66%	60%	64%	67%	54%	67%

Finally, in order to evaluate the performance of PE-owned businesses against comparable public companies, we have compiled data on public companies by country and sector over the same time period as the PE exits in our sample. The data was then aggregated to compare PE performance to that of public companies.

The ability to incorporate data obtained directly from interviews with top PE investors is an important feature of the study. Another is the scope and depth of our research, with a database of more than 470 European PE exits. Our study is recognized by many commentators as the authoritative work in this field.



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