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Apax Partners Funds invest in companies across its global sectors of Tech & Telecom, Retail & Consumer, Media, Healthcare and Financial & Business Services.

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Foreword

Martin Halusa, CEO, Apax Partners

Private equity has entered the economic mainstream. Four years ago, when we published our previous report[1] on trends in the private equity industry, private equity was already firmly identified in investment portfolios as an alternative asset class.

Since then the buyout end of the industry, the principal focus of this report, has expanded dramatically. Deal sizes have increased. Liquidity has improved. Private equity ownership of household corporate names is now commonplace. But we believe that private equity's greatest growth is yet to come.

Of course, there are risks. Debt markets, which have grown dramatically and been favourable and accommodating of the industry's leverage requirements, could be negatively affected by a major corporate collapse, a surge in interest rates or an unforeseen cataclysmic event.

The world's economies could suddenly slow or move into recession. This would have a powerful impact on highly leveraged companies dependent on economic buoyancy to meet their covenants. Exit values would plunge if stock markets dramatically fell. Assets bought at reasonable prices today would, in hindsight, seem overpriced were any of these risk factors to come to pass.

These risks exist, but the probability is low. There is currently no tangible reason for any of these things to happen. It is more likely that the current favourable climate will continue. Even if the industry were to slide into a cyclical low, which it eventually will, we believe returns of the top quartile funds will still remain significantly above public market returns.

The private equity industry has matured. Managing risk in cyclical markets is an essential part of what we do. Our success has been in large part due to our ability to deliver exceptional returns, irrespective of market conditions, to our investors. The challenge is to maintain that performance as the scale of our opportunities and operations continues to grow.

For many in the industry the issue of succession, building an institution that can outlive its charismatic founders, is pressing. Apax Partners is fortunate to have successfully managed that transition. We are the second generation of our firm and we are optimistic about the future prospects for our industry.

April 2006

1. Apax Partners: "The double helix: Entrepreneurship and private equity", 2002

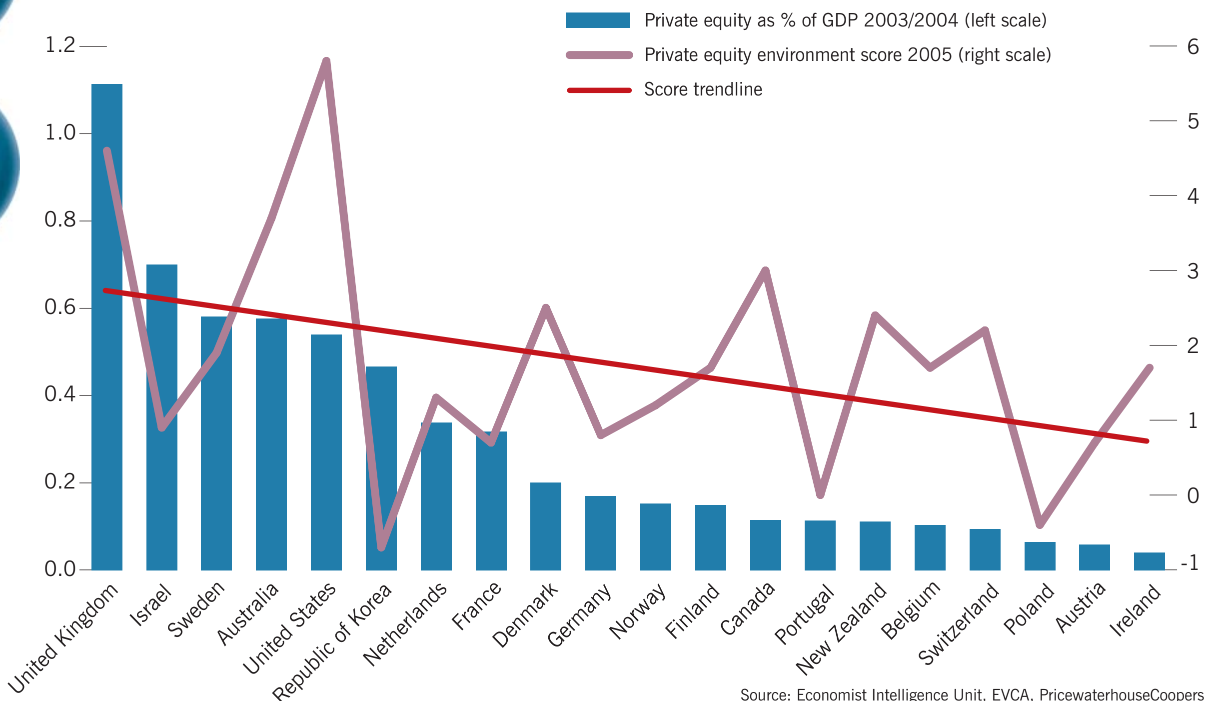
EXECUTIVE SUMMARY

Private equity has enjoyed dramatic growth in recent years. In the US and the UK in particular, private equity and public markets are no longer alien investment planets but are starting, albeit gradually, to converge. Yet the industry's potential for expansion, in these countries and beyond, is vast. The supply of money into the industry will rise as institutional investors seek out superior returns, as funds-of-funds facilitate access to the asset class for high net worth individuals, and as management teams recognise the advantages and efficiency of private ownership. Private equity funds worth US$20bn or more are likely in the next five years.

Globalisation will be a defining theme for the industry in the coming years, and a critical source of growth. If the value of private equity activity in every OECD country were to reach the simple, and comparatively modest, benchmark of 1% of GDP, another US$200bn would be added to the global investment total. As a new global ranking of 33 countries produced especially for this report shows, the quality of the national private equity environment helps determine the size and success of the industry in that country.

The world's best markets for private equity have similar economic characteristics—stable regulatory environments, liberal policies towards private enterprise, well-funded financial systems and an appetite for entrepreneurship. In these nations, the industry's chal-

The importance of environment



Source: Economist Intelligence Unit, EVCA, PricewaterhouseCoopers

lenges will be those associated with growing maturity, such as demands from investors and regulators for increased disclosure and for a more transparent approach to valuation.

The major markets of Japan and continental Europe have performed less well in terms of market growth. There is a clear trend towards greater investment into private equity in Europe in particular, although the continent will not maximise its potential until it genuinely integrates both its regulatory regimes and its capital markets. The industry will not properly take off in the world's major emerging markets in the next five years, given their hugely challenging operating environments.

As the scale of dealmaking and the level of competition for the most prized assets increases, private equity firms will no longer be able to rely on arbitrage or financial engineering to generate returns. Value creation will derive from active ownership of companies. Successful firms will be those that can see value-creating opportunities prior to the transaction and deliver on them afterwards.

Sectoral expertise, global reach, deep pockets and professional back-office operations will be the hallmarks of the leading private equity players. Smaller players will be able to find niches in specialist markets and industries. Venture capital remains an essential part of the private equity food chain. But the industry's growth will be primarily driven by a leading group of large firms whose core business is buyouts.

1 THE POTENTIAL OF PRIVATE EQUITY

The lines between private equity and public markets are gradually converging as deal sizes and liquidity increase

The buyout and venture capital ends of the industry are diverging as the scale of buyout fundraising increases

There remains tremendous potential for growth in both developed and developing markets

Private equity is maturing fast. A recent study by the Munich Technical University for the European Private Equity and Venture Capital Association (EVCA) found that between 2000 and 2004, European businesses acquired in buyout deals recorded a net increase of 420,000 jobs.[2] A similar survey for America's National Venture Capital Association (NVCA) found that in 2003, private equity-backed companies employed more than 10m US workers and accounted for US$1.8trn in sales.[3]

The superior returns generated by the best private equity firms ultimately filter back to millions of individuals with pensions and other personal savings and investment plans. In the US about 4% of total investment assets, totalling almost US$900bn, was held in private equity (including venture capital) at the end of 2004.[4] Among large US institutional investors, the ratio is higher, and set to rise further. In 2005, a survey of 176 leading US and Canadian institutions by Russell Investment Group found that on average, private equity accounted for 7% of their asset allocation. In the same study, 65 major European institutions reported average private equity allocations of 4.5%.[5]

This influx of capital is having its greatest impact on the buyout end of the private equity industry. In 2005, eight funds were opened which aimed to raise more than $5bn, compared with just one $5bn-plus fund for the whole of 2004.[6] An emerging "bulge bracket" of top buyout firms are already looking forward to the day when $10bn-plus funds are commonplace.

Private equity fundraising
2005 (US$bn)

	Number of funds	Amount
Buyout funds	134	120.6
Venture capital funds	225	35.7

Source: Thomson Financial Venture Economics

Most major buyout firms have little or no involvement in pure venture capital, where there is less money and higher risk. The potential to make exceptional returns from venture capital still exists—witness the examples of Google and Skype—but few private equity professionals believe that venture capital will recover its heady position in the late 1990s, when it was the industry's principal growth motor.

The reasons for the buyout industry's dramatic expansion are clear. Perceptions of relative risk between privately- and publicly-held asset classes have changed, given the 2000-01 stockmarket crash and the consistently high returns of the best buyout funds. According to a study of US private equity performance between 1980 and 2001 by Steve Kaplan of Chicago University

Rising sum: Global funds over US$5bn

Fund Year	Firms	Funds	Aggregate capitalisation (US$m)	Average capitalisation (US$m)
2000	4	4	23,155.60	5,788.90
2001	2	2	11,640.00	5,820.00
2003	4	4	23,634.10	5,908.50
2004	1	1	7,850.00	7,850.00
2005	8	8	62,570.40	7,821.30

Source: Thomson Venture Economics / NVCA (for US Venture Capital data)

2. EVCA: "The Employment Contribution of Private Equity and Venture Capital in Europe", November 2005

3. Global Insight: "Venture Capital Benefits to the US economy", 2004

4. Freeman & Co. report: "Convergence in Alternatives", November 29 2004

5. Russell Investment Group: Russell Survey on Alternative Investing 2005-2006"

6. Thomson Financial Venture Economics

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and Antoinette Schoar of MIT, the top quartile of buyout funds produced an average annual rate of return of 23%, significantly more than the S&P 500.[7]

The allocation of capital to private equity is also being accelerated by the sector's increasing liquidity. Investors, including wealthy individuals, now have increasing access to private equity, either through listed buyout firms (still only a handful), or through funds of private equity funds. The appetite for this latter investment vehicle is expanding rapidly. Funds-of-funds have taken off in the US, where total capital raised by the sector more than doubled between 2003 and 2004 from US$3.5bn to US$7.9bn.[8] That is substantially more than the value of overall private equity activity in Germany that year.

There has been a widening of the available exit strategies at the end of an investment. Traditionally, private equity firms chiefly relied on a stock market flotation or sale to a trade buyer to realise returns. These days, secondary buyouts—in which one private equity owner acquires an asset from another—form an increasingly popular exit option. Dealogic reports that from 2003 to 2004, the total value of secondary buyouts in the US rose from US$6.3bn to US$21bn. In the UK, Barclays Private Equity estimates that secondary buyouts now account for 40% of the total value of the buyout market, compared with 5% in 2001.

Listed companies are also altering their view of private ownership, as they tire of the short-term demands of shareholders. In 2005, the global value of deals in which the acquired company subsequently delisted reached US$66.5bn, more than double the value of such deals in 2004.[9]

There is frequently a gulf at publicly listed companies between the interests of the managers of the business and the shareholders. "It's very difficult for a fund manager owning 3% of any company to influence what that company does," says one buyout professional. By contrast, private equity firms, either alone or in a consortium, typically own most, if not all, of their acquisitions. They are the sole shareholder, answerable to their limited partners for the success of the businesses they acquire. They have the power to restructure those businesses, sometimes by bringing in new management. They can ensure that those managers are remunerated in such a way that they, too, have a direct stake in maximising the company's value. And they can leverage their returns by fully using the debt capacity of the firm without being penalised by outside shareholders.

7. Steve Kaplan and Antoinette Schoar: "Private Equity Performance: Returns, persistence and capital flows". Journal of Finance, April 2005

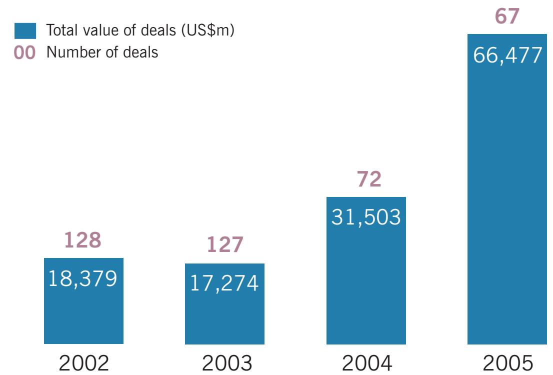
8. Almeida Capital: "A review of private equity funds-of-funds", April 2005

9. Thomson Financial Venture Economics

10. Out of 33 countries examined in this report, see page 11

Going private

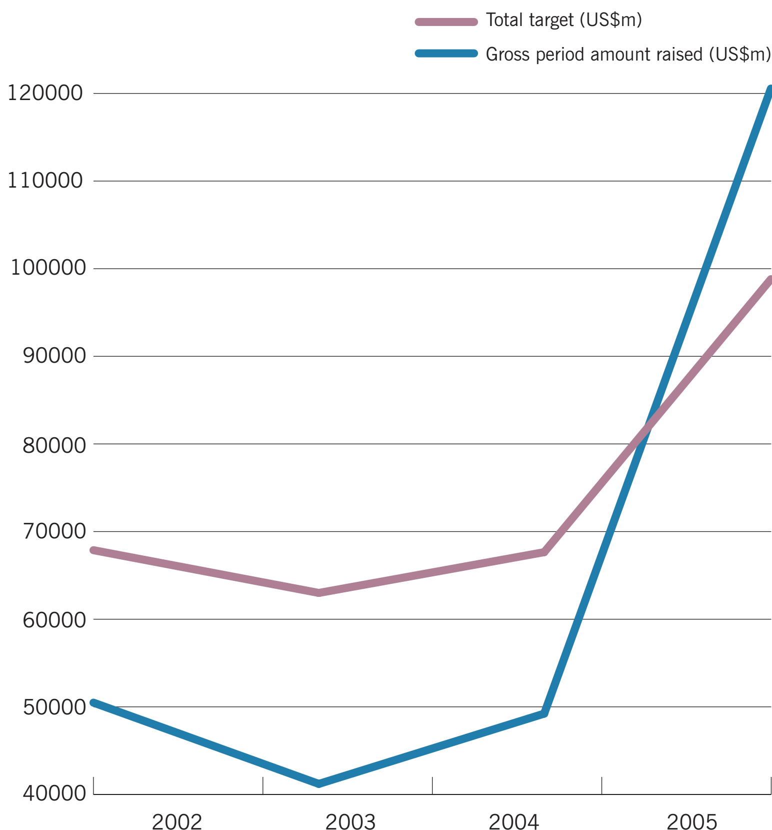
Value of deals in which acquired company subsequently delisted



Source: Thomson Financial

Demand explosion

Total private equity funds raised, US$1bn and over, 2002–2005



Source: Thomson Venture Economics / NVCA (for US Venture Capital data)

Realising the industry's potential

The potential for further expansion remains exceptional:

- When measured as a percentage of overall economic activity, private equity accounts for over 0.5% of GDP in just five countries[10]—the UK, Israel, Sweden, Australia and the US. Only in the UK is private equity activity worth more than 1% of GDP. Bringing

other OECD countries up to that simple benchmark would add almost US$200bn to the value of private equity activity worldwide (see chart).

- The buyout sector is concentrated predominantly in the US, the world's largest private equity market, and the UK, Europe's pre-eminent market. The growth opportunities represented by the globalisation of the industry beyond these two countries are huge.

- Although private equity firms now control a host of household names, they still lack the financial clout to take aim at the largest buyout opportunities. The top buyout firms clearly now have the resources to get access to US$10bn-plus deals. But these deals are still at the mid-cap level, well short of the mega-deals available to the largest trade buyers.

For this potential to be realised, three conditions must be met. The first condition is for the supply of money into private equity to continue to rise. The prospects of this happening are extremely promising, given the industry's recent fundraising performance (see chart on page 8).

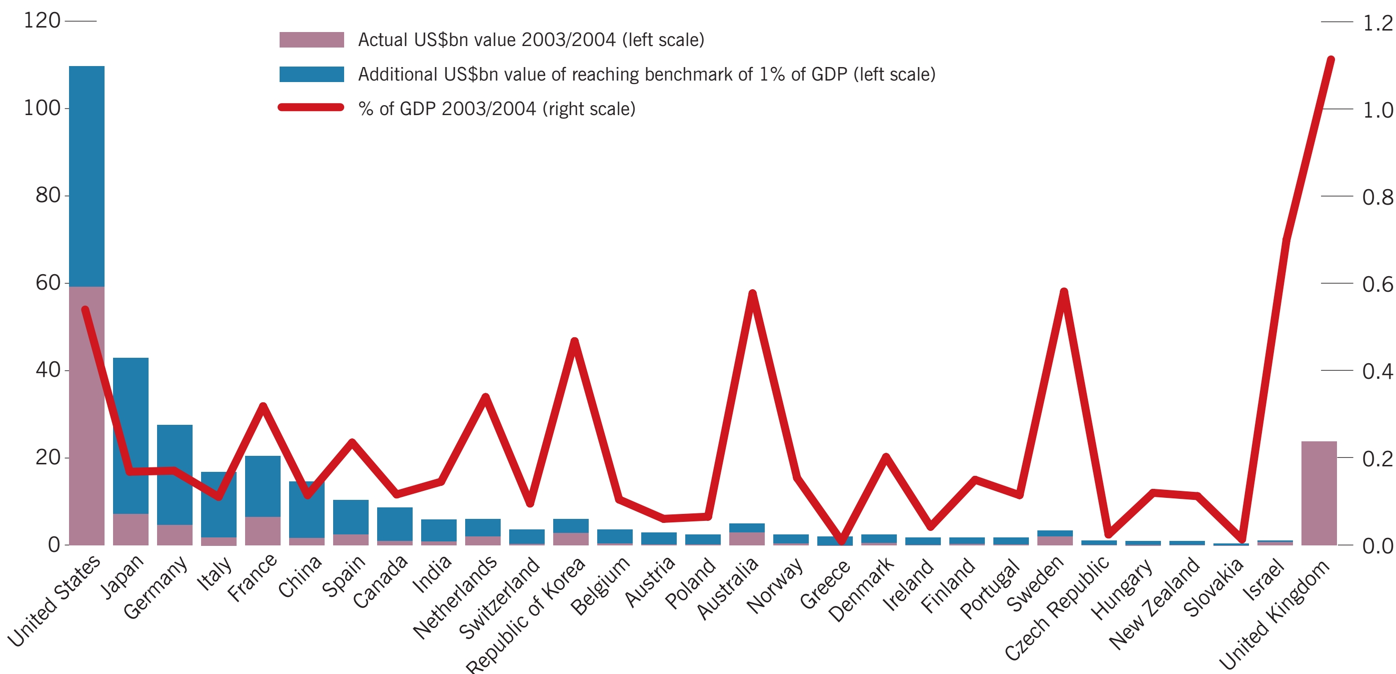
The second condition is for private equity to globalise. A new global ranking produced especially for this report illuminates the areas in which countries—and governments and regulators, in particular—must focus in order to create a more fertile environment for the industry.

The third condition is for the industry to continue to deliver superior performance while taking on some of the attributes of more mature sectors. Private equity firms can no longer rely on arbitrage or clever financial engineering alone to add post-deal value. Buyout bargains are increasingly rare, now that almost all major deals are decided by auction. Previously arcane financial instruments like debt derivatives are standard offerings in an investment bank's product suite. That leaves only one sure route to value creation: painstaking improvement of a portfolio company's performance.

If these conditions are met, the industry will continue to achieve dramatic rates of growth. The arrival of the first US$20bn fund is likely over the next five years. Levels of private equity activity could easily rise by more than US$50bn in continental Europe alone. It is only a matter of time before private equity-backed takeovers of S&P500 and FTSE 100 firms are commonplace. The US$100bn fund is imaginable within twenty years.

The US$200bn prize

Incremental value of private equity activity reaching 1% of GDP in individual countries



Source: Economist Intelligence Unit, EVCA, PricewaterhouseCoopers
Private equity activity refers to the total value of private funds that are based within each country, with the exception of the US, where the figure refers to the total value of all private equity investment, regardless of national origin.

2
GLOBALISATION AND PRIVATE EQUITY

The US and UK, the world's best private equity environments, will face increasing demands to improve disclosure

Continental Europe and Japan will have to overcome cultural and regulatory barriers in order to realise their full potential

The world's large emerging markets have plenty of potential but are longer-term bets

Private equity is an industry that is still heavily concentrated in two economies, the United States and the United Kingdom. Eight out of the top ten global private equity firms, measured by capital under management, are all American, or have a strong American presence. In the first ten months of 2005, North America (including Canada) accounted for 60% of all new private equity funds raised globally. In the same period, 75% of all private equity investment (including venture capital) was made in the US.[11]

Europe is responsible for almost all the world's remaining private equity transactions, but more than half of these funds are under management in the UK and 37% of all funds raised in Europe in 2004 were sourced in the UK.[12]

The sheer size and wealth of the US and UK economies, the world's richest and fifth-largest respectively, play their part. But size is not everything. Private equity activity in Germany, the world's third-largest economy, was worth just US$4.7bn in 2004, far behind the UK's US$23.7bn. So what is it that separates these countries?

The answer lies in the environment they offer. The US and UK rank first and second in a new global ranking of 33 national private equity environments produced especially for this report. The global ranking is based on a series of quantitative and qualitative measures in five categories: the overall environment for private enterprise; the financing environment; market opportunities; the legal and policy environment; and the entrepreneurial environment.

The ranking is not a perfect indicator of private equity activity. The lure of larger markets such as China and India will outweigh many of the flaws in their business environments, for example. Outperformance in key areas can make up for weaknesses elsewhere—Israel's energetic support for its venture capital industry, for example, helps make it the leading non-OECD economy.

Private equity environment rankings 2005

Rank	Country	Score
1	UNITED STATES	5.8
2	UNITED KINGDOM	4.6
3	AUSTRALIA	3.7
4	CANADA	3.0
5	DENMARK	2.5
6	NEW ZEALAND	2.4
8	SWITZERLAND	2.2
7	SWEDEN	1.9
9	BELGIUM	1.7
10	IRELAND	1.7
11	FINLAND	1.7
12	NETHERLANDS	1.3
13	NORWAY	1.2
14	ISRAEL	0.9
15	GERMANY	0.8
16	AUSTRIA	0.7
17	FRANCE	0.7
18	PORTUGAL	0.0
19	POLAND	-0.4
20	KOREA, REP. OF	-0.7
21	SPAIN	-0.8
22	HUNGARY	-0.9
23	JAPAN	-1.1
24	ITALY	-1.7
25	SLOVAKIA	-2.1
26	CZECH REPUBLIC	-2.2
27	GREECE	-2.3
28	TURKEY	-3.7
29	BRAZIL	-4.0
30	RUSSIA	-4.0
31	MEXICO	-4.2
32	INDIA	-4.3
33	CHINA	-5.3

Source: Economist Intelligence Unit

11. All figures from Thomson Venture Economics/NVCA

12. EVCA/Thomson/PricewaterhouseCoopers: "EVCA Final Activity Figures for 2004"

But the trend is marked: countries that offer stable regulatory frameworks, encourage market-based competition, have highly developed financial systems (which usually means well-funded private pension funds), and foster entrepreneurial policies and attitudes are likely to have higher levels of private equity activity.

Behind these leading nations—which include Australia, Canada, New Zealand and the Scandinavian countries, as well as the US and UK—comes a cluster of continental European countries, as well as Japan and Korea. Often the overall environment for private enterprise in these countries is good and the potential for buyout activity is high. Many also boast decent financing environments. However, most of these economies also have their issues when it comes to private equity activity: fragmented capital markets, restrictive labour laws and undeveloped entrepreneurial cultures all hamper the development of private equity.

Bringing up the rear are the world's four major emerging markets—Russia, Brazil, India and China. While no one questions the enormous potential of each country, it is some way from being realised, thanks to their developing policy and financial environments.

The leading nations: The challenge of maturity

Every country in the ranking has room for improvement, as the following chapter of country profiles demonstrates. But the rankings suggest that today's pre-eminent private equity markets are unlikely to lose their (considerable) lead over the next five years. Private equity requires a rich mixture of entrepreneurial dynamism, financial depth and stable regulatory environments to thrive. It is not a recipe that can be quickly replicated.

Indeed, the gap between the Anglo-Saxon economies and the rest is likely to widen before it starts to narrow. Not only are the absolute volumes of investible capital in these markets bigger, investors' relative allocations to private equity are also higher. By 2007, leading US and UK institutional investors expect to increase their private equity holdings to an average of 7.9% and 6.7% of their total portfolios respectively, according to a 2005 survey by Russell Investment Group.[13] That compares with forecast allocations of 6.1% and 4.5% in Europe and Japan respectively.

It is not enough for a private equity firm to amass a huge pile of money, of course. The capital then has to be invested. Fortunately, the demand on the part of vendors and management teams for intelligent and well-executed private equity investment will continue to grow.

The constraints imposed in the US by the 2002 Sarbanes-Oxley legislation and on both sides of the Atlantic by other similar pieces of regulation on financial and accounting disclosure are just one factor encouraging more listed companies to go private. The private markets also put a more accurate value on the risk of debt than public markets. Private equity enables companies to access a more efficient debt market, where credit risk is calculated according to the merits of a business plan rather than the potential impact on the share price.

The flow of corporate talent from public companies into private equity will also increase. A survey in 2005 by the *Financial Times* and the UK's Finance Directors' Forum found that among a sample of senior managers at 160 companies, 57% of all respondents—and an even higher proportion from quoted businesses—thought that public companies would find it harder in future to prevent key executives leaving for a job in private equity. A further 46% reported that they were more tempted to work in private equity than a year before; and over three-quarters said they would definitely or probably consider a position in the industry.

As the profile and importance of the industry rises, so will the interest of the outside world. There will be increasing interchange between the private equity sector and regulators in the world's most developed markets, as both sides work towards a common set of standards and rules for a fast-maturing industry. Two areas in particular, disclosure and valuation, will preoccupy them.

Private equity's opaque reputation is in many ways unjustified. There is a constant flow of information between general partners from the buyout firm and limited partners such as institutions and endowments that invest in major buyout funds.

Private equity firms will nevertheless face increased pressure to put more performance data in the public domain. Large public pension funds in the US have already faced a series of freedom of information suits for greater disclosure of their private equity investments. In 2002, for example, the San Jose Mercury News sued the California Public Employees' Retirement System (CalPERS), in an attempt to force the pension fund to disclose its private equity returns. The same year, a similar suit was filed against the University of Texas's investment fund by a Texas newspaper. In many other US states, similar freedom of information suits have either been filed or are pending. The result has been a rash of laws enacted by state legislatures that define how much public pension schemes and endowments must reveal about their private equity holdings.

Given their inconsistency, the overall impact of these rulings on the US private equity industry is still unclear. In one case, a private equity firm expelled a state university from its new fund, rather than see performance data released for wider inspection. On the other hand,

13. Russell Investment Group: "Russell Survey on Alternative Investing 2005-2006"

US and them

Ranking of private equity firms by capital under management, year to September 2005

Rank	Firm Name	Fund Size (US$m)	% of total	Number of funds	Avg Fund Size (US$m)
1	Goldman, Sachs & Co.	35,885.20	2.20	24	1,495.20
2	Blackstone Group, L.P.	30,891.60	1.90	13	2,376.30
3	Carlyle Group, The	28,877.70	1.80	36	802.20
4	Warburg Pincus LLC	21,810.00	1.30	6	3,635.00
5	Kohlberg, Kravis, Roberts & Co. (AKA: KKR)	20,466.70	1.20	4	5,116.70
6	Apax Partners Worldwide	20,105.60	1.20	24	837.70
7	Apollo Management (FKA: Apollo Advisors L.P.)	19,000.00	1.20	5	3,800.00
8	HarbourVest Partners LLC	17,672.50	1.10	23	768.40
9	Oaktree Capital Management, LLC	17,581.30	1.10	18	976.70
10	CVC Capital Partners	15,343.50	0.90	4	3,835.90

Source: Thomson Venture Economics / NVCA (for US Venture Capital data)

an increasing number of large US public pension funds now publish the performance of private equity funds where they are invested.

Those who have most to fear from greater transparency are the poorer performers. Between 1980 and 2001, the average US buyout fund delivered marginally lower returns to investors (after general partner fees) than if the money had simply tracked the S&P 500.[14]

There is no reason why top quartile firms should fear more disclosure at the fund level, provided the public spotlight does not extend to individual company balance sheets. Making such detailed information public would undermine the whole point of taking a business private.

Fair value?

Building a consensus about the appropriate amount of disclosure cannot be achieved without agreement on the complex question of how to value portfolios. The traditional method of valuing private equity holdings by taking the cost of the original investment as the benchmark often fails to account for growth in profitability, debt repayment, market movements and other factors while an asset is under management.

A more effective valuation method is on the basis of "fair value". That means trying to measure the value of an asset if it were to be sold on the current open market between willing parties. This is no straightforward task, of course. Markets are volatile, and the perceived value of an asset can depend on whether there is only one interested buyer, or whether there are multiple bidders, as in a takeover battle. Moreover, there is the problem of how to consolidate the values of individual portfolio companies that operate in different sectors, like energy and consumer retail goods.

Internal and external auditors at private equity firms wrestle with such technical issues every day, however, and manage to resolve them. If the current trend in favour of fair value book-keeping continues, there is no reason why the global industry cannot eventually agree common rules for portfolio valuation that will satisfy US and European regulators (and by extension, regulators of Asia's fledgling private equity market, who are likely to follow the West's lead).

Indeed, progress towards common valuation of portfolios is already being made. In September 2004, a US industry working party put fair value at the centre of recommended accounting procedures.[15] Since the guidelines are voluntary, the key to their success is the adoption rate. Research by the Tuck Business School's Center for Private Equity and Entrepreneurship suggests that the guidelines have a reasonable chance of becoming the industry standard in the next few years.[16] They have been endorsed by America's Institutional Limited Partners Association (ILPA), whose 130 members collectively manage more than US$300bn of funds.

The less developed markets: Poised for growth?

Four of the world's seven largest economies—Germany, France, Japan and Italy—sit at lowly 15th, 17th, 23rd and 24th spots in the private equity environment rankings respectively. This, however, does not reflect the performance of individual private equity investments in these countries were returns can be exceptional. All are potentially huge markets for private equity, given their size, their scope for restructuring and their developed regulatory environments. But they have not done enough so far to encourage either private equity, particularly from overseas, or entrepreneurialism.

Undeveloped private pension schemes, restrictions on foreign investment and restrictive labour laws have

14. Steve Kaplan and Antoinette Schoar: "Private Equity Performance: Returns, persistence and capital flows". Journal of Finance, April 2005

15. Private Equity Industry Guidelines Group (PEIGG): Valuation Guidelines, September 2004

16. Venture Capital Journal, June 2005

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Has continental Europe's time come?

Top 10 private equity buyouts in 2005 (US$)

Company	Amount	Sector	Country
Hertz	$15bn	Car hire	US
TDC	**$14.1bn**	**Telecoms**	**Denmark**
Wind	**$12.8bn**	**Telecoms**	**Italy**
SunGard	$10.9bn	Data systems	US
Viterra	**$8.97bn**	**Real estate**	**Germany**
Toys "R" Us	$6.01bn	Retail	US
Amadeus	**$5.82bn**	**Travel booking system**	**Spain**
Neiman Marcus	$5.09bn	Retail	US
Intelsat	$5bn	Satellite technology	Bermuda
CoralEurobet	$3.88bn	Gambling	UK

Source: Thomson, companies.

all served to dampen their appeal. There is also a lingering antipathy to international private equity investment—witness the public condemnation of foreign "locusts" by a mainstream German politician in 2005.

Japan's buyout market has suffered a particularly bumpy ride recently. In the first six months of 2005, the Asian Venture Capital Journal estimates that the total value of all private equity deals (dominated by buyouts) was US$1.6bn, compared with US$3.5bn in the first half of 2004. The fall partly reflects an anticipated increase in transaction costs, following the introduction of a new withholding tax that targets foreign buyout firms. Nonetheless, Japan represents a potentially huge market for buyout specialists, because the country is still packed with large industrial holding groups that are ripe for restructuring.

There are encouraging signs that investors in continental Europe are starting to shift capital into private equity. The second and third largest buyouts of 2005 took place in Europe. The restructuring of Europe's industrial landscape is only half-complete, and there are many former state-owned companies or industrial conglomerates that represent attractive buyout targets for private equity firms.

In 2004, private equity investments in Germany rose by 60% to €3.8bn, of which 67% was devoted to buyouts.[17] Such investment, while still small, would have been unimaginable until recently. It was only when leading German companies like Deutsche Telekom and Lufthansa began selling divisions to international buyout firms that the local private equity sector took off. Today, buyout activity is principally generated by German industry's continuing "de-conglomeration" story, as a steady stream of large and medium-size companies look to sell non-core assets. The new coalition government led by Angela Merkel is committed to building a more entrepreneurial culture—one in which private equity is bound to feature prominently—as probably the most effective way to address Germany's crippling unemployment problem.

France is another European country where private equity investment is on the rise. In 2004, total private equity investment reached €6bn, compared with €3.6bn the previous year.[18] Most of this capital came from local sources, but international private equity firms are also now moving into the French market and buying household names. The outstanding acquisition so far is Rexel, the electrical goods supplier, which was bought in 2004 by a consortium of private equity funds in a deal valued at more than €3bn.

France's government is also showing signs that it understands the need to nurture private equity investment. In September 2004, representatives of the French insurance industry signed a non-binding three-year agreement with the government to raise their private equity investments from 1.4% of total assets under management to 2%. If the target is achieved, Almeida Capital forecasts that an additional €6bn of capital will flow into French private equity funds by 2007.[19]

Optimism about the development of private equity in continental Europe needs to be qualified, however. The EU's patchwork quilt of separate national regulatory regimes has a direct impact on the region's private equity firms (including those in the UK). To trade throughout Europe, firms have to cope with multiple sets of regulation. But in the US, which is a single market, there is one set of regulations for the whole of the country. Compared with top US buyout groups, European private equity firms tend to be small and confined to national markets. In 2004, only 14% of all private equity and venture capital investments in Europe were outside the country of origin.[20]

The European Commission's 2004 Green Paper on Financial Services Policy does call for consolidation of EU financial services legislation over the next five years and reiterates Brussels' desire to see a pan-European investment structure for private equity and venture capital. It is perhaps more realistic to accept that even the smallest EU member states will retain their own regulatory regimes and hope instead that national regulators will increasingly compete with each other over best practice, for fear of businesses migrating to other jurisdictions. In this respect, it is no coincidence that the UK—the EU member with the most favourable regulatory environment for private equity—is also where the bulk of the industry in Europe is based.

A second, and related, problem is that Europe has failed to make significant progress towards developing

17. German Venture Capital Association, 2004 report

18. French Venture Capital Association, 2004 report

19. Almeida Capital: Alternative Assets newsletter, May 17 2005

20. EVCA: "Final Activity Figures for 2004"

effective transnational trading platforms. Properly managed, integrated financial exchanges would radically lower transaction costs and thus liberate capital to boost investment in both the public and private markets. At a secondary level, an effective transnational stockmarket for growth companies would greatly increase the exit opportunities for European venture capital and buyout firms with small and mid-size assets in their portfolios.

The obstacles in the way of a pan-European capital market are formidable. Shareholders in the three main European exchanges are concerned about the possibility of a value-destroying or power-shifting merger. Regulators have legitimate worries about competition issues, especially involving the creation of vertical trading, clearing and settlement platforms. Yet the demand among public and private equity investors for a unified European capital market has never been greater. It cannot come too soon.

The emerging markets: One BRIC at a time

The growth potential in the world's large emerging markets—Brazil, Russia, India and China, the so-called BRIC countries—is even more explosive than that of continental Europe. China in particular hit the headlines in October 2005 when Xugong, the country's leading construction equipment firm, was to be bought by Carlyle Group for US$370m. Xugong is easily China's biggest private equity buyout to date, with the prospect of more such deals as the government restructures the ailing state-owned industrial sector.

Yet foreign buyout groups will remain wary of committing too much capital to a country that ranks last in our list of private equity business environments. Entering the Chinese market as a foreign private equity firm is extremely challenging. Legislation governing foreign investment can be bewildering; collecting data on potential acquisition targets is difficult; and gaining meaningful management control of domestic firms is a highly politicised process. One stumbling block is the inconsistent regulatory approach of the Chinese government. For example, a ministerial circular last year imposed foreign exchange controls that blocked mainland residents' ability to sell assets to overseas buyout firms. Following protests by investors, the government is now reportedly exploring ways to ease the transfer of equity abroad through cross-border share swaps.

India also enjoys vast potential. A raft of state-owned industrial giants are being broken up; family-owned Indian companies need more funding as they push into international markets; and the country has a well-educated business elite that includes some of the best high-tech brains in the world. But the small scale of private equity investments (US$1.1bn in 2004) reflects India's considerable obstacles. Too many entrepreneurial firms are still mired in red tape, and at the buyout end of the industry, the barriers to market entry remain formidable for international private equity groups.

In Russia, non-bank finance remains underdeveloped, while there is no legal definition of a VC fund. Additionally, the court system is still a poor mechanism for protecting shareholder rights and Russia has taken few steps to strengthen regulation of the auditing profession. And in Brazil, although pension fund investment in private equity is growing, the overlapping jurisdictions of regulators and tax authorities at the municipal, state and federal levels, the cumbersome judicial and tax systems, labour-market rigidities and the weighty bureaucracy all act as a drag on private enterprise.

These emerging markets may eventually rival Europe or America as a focus for private equity investors. But a sense of perspective is required. These are countries with complex operating environments, interventionist attitudes to private enterprise, and undeveloped financial and industrial bases. They are markets for the long-term future.

3

PRIVATE EQUITY ENVIRONMENT RANKINGS: COUNTRY PROFILES

The Economist Intelligence Unit's private equity rankings seek to measure the attractiveness of the business environment in 33 countries to international and local private equity firms. The rankings are derived from qualitative and quantitative research into 37 aspects of the national business environment. The criteria were selected by the Economist Intelligence Unit in consultation with Apax Partners and grouped into five categories. An explanation of the rankings methodology and the full list of criteria can be found on page 25.

1

United States	Rank
Overall environment for private enterprise	5
Financing environment	1
Market opportunities	1
Legal and policy environment	2
Entrepreneurial environment	1

The United States easily tops our ranking, coming out some distance ahead of the second-placed UK. Of the five categories ranked, the US comes first in three—the financing environment, market opportunities and entrepreneurial environment—and second for its legal and policy environment.

Strengths: As the world's pre-eminent economy, it is no surprise to see the US lead the market opportunities category. However, it is in its financing environment that the country holds its most significant advantage over competitors. The openness of the US financial sector means that it is undergoing constant change, which, in turn, creates new forms of competition and stimulates innovation. Furthermore, with a stockmarket capitalisation some five times higher than its nearest rival, Japan, the financing depth in the country is unparalleled.

Weaknesses: Serious structural imbalances in the US economy raise the spectre of rising interest rates and, in the longer term, sluggish growth. US capital markets retain a significant measure of risk, especially in those segments attracting heavy inflows of speculative funds at any point in time. The national culture is relatively open towards foreign business influence but there is a strong undercurrent of protectionist sentiment.

2

United Kingdom	Rank
Overall environment for private enterprise	2
Financing environment	3
Market opportunities	2
Legal and policy environment	1
Entrepreneurial environment	6

The UK ranks second overall, and first in Europe, for its private equity environment. It is some way ahead of third-placed Australia, but by the same token, lags considerably behind the US. The UK government operates with a very light touch in the corporate arena, giving business as much freedom as possible to compete without state intervention.

Strengths: The UK has a particularly good legal and policy environment, ranking better than any other country. Among its most significant advantages in this area are an extremely flexible labour market and a government which is very encouraging of private equity. Alongside its favourable regulatory environment, the UK has, proportionally, the highest level of M&A activity of any country surveyed, an indicator of excellent dealmaking opportunities for private equity firms.

Weaknesses: The UK is one of the few countries in the OECD where R&D expenditure as a share of GDP has fallen over the past 20 years. Whereas the UK's expenditure on R&D as a share of GDP, at 2.4% in 1981, was above the EU and OECD averages, it has now fallen to 1.9% of GDP.

3

Australia	Rank
Overall environment for private enterprise	1
Financing environment	7
Market opportunities	3
Legal and policy environment	13
Entrepreneurial environment	2

The environment for private equity in Australia is favourable, ranking third overall behind the US and UK. It has the best environment for private enterprise in our survey: the Australian government applies a free-market, pro-competition philosophy to economic activity.

Strengths: The country scores extremely well for its entrepreneurial environment and there are plenty of market opportunities for private equity firms. When measured as a percentage of GDP, M&A activity is second only to the UK.

Weaknesses: The only category in which Australia scores averagely is for its legal and policy environment. It scores poorly against the other leading countries for the restrictiveness of its labour laws and for its relatively high tax rates.

4

Canada	Rank
Overall environment for private enterprise	9
Financing environment	4
Market opportunities	7
Legal and policy environment	5
Entrepreneurial environment	4

Canada ranks fourth in the world for its private equity environment, behind the US, UK and Australia. Although non-bank sources of finance play a secondary role in financing Canadian business activity, the largest pension funds are becoming more aggressive private equity investors in an effort to improve their returns.

Strengths: Canada's main advantages lie in its financing and entrepreneurial environments. According to the World Bank, the amount of time needed to set up a new business in Canada is the lowest in the OECD. This, coupled with low personal income tax and capital gains tax rates, encourages entrepreneurialism.

Weaknesses: Despite the general openness of the Canadian economy to foreigners, there are restrictions in specific industries such as banking and financial institutions, broadcasting, telecommunications and real estate. The federal government has announced its intention to review the financial sector regulatory framework, with an emphasis on improving the efficiency of capital markets.

5

Denmark	Rank
Overall environment for private enterprise	3
Financing environment	12
Market opportunities	17
Legal and policy environment	4
Entrepreneurial environment	5

Denmark is the top-ranked non Anglo-Saxon economy, placing it above all other European countries except the UK. Denmark offers private equity firms some distinct advantages. Along with its Scandinavian counterparts, Denmark is often considered a useful "test-bed" market for new technologies, because of its fairly even income distribution and generally high levels of education.

Strengths: The quality of its overall environment for private enterprise is bettered only by Australia and the UK, thanks to the strength of its judicial systems, lack of corruption and protection of intellectual property. Denmark also scores highly for its flexible labour market and well-educated workforce.

Weaknesses: Low stockmarket capitalisation adversely affects the country's financing environment and market opportunities are also held back by fairly sluggish GDP growth and relatively limited scope for consolidation.

6

New Zealand	Rank
Overall environment for private enterprise	7
Financing environment	11
Market opportunities	10
Legal and policy environment	15
Entrepreneurial environment	3

New Zealand ranks a creditable sixth in our survey, although this still puts it behind its neighbour, Australia, and also behind most of the other Anglo-Saxon economies. New Zealand scores particularly highly for its entrepreneurial environment.

Strengths: The country has a small but open financial sector, and a liberal stance on trade and capital flows. The deep, wide-ranging economic reforms of the 1980s and 1990s have helped create a competitive and liberal environment for private enterprise.

Weaknesses: Market opportunities are the main area of weakness, reflecting the country's small population, the small economy and isolation from major business centres. New Zealand's equity market is small by international standards and will continue to suffer from a lack of liquidity. The corporate tax rate is higher than in Australia.

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7

Switzerland	Rank
Overall environment for private enterprise	4
Financing environment	5
Market opportunities	16
Legal and policy environment	7
Entrepreneurial environment	13

For Switzerland, ranked 7th overall, the results are a mixed bag. While it scores well for its overall environment for private enterprise and—hardly surprisingly—for its financing environment, it scores relatively poorly when it comes to market opportunities and entrepreneurial environment.

Strengths: Switzerland's financial markets are characterised by excellent depth, quality and stability. Swiss interest rates remain among the world's lowest and tend to be lower than in both the US and the euro-zone countries. The quality of the Swiss bureaucracy is good and high wage costs are offset by a high level of labour market flexibility.

Weaknesses: Market opportunities will remain limited in part because of the small size of the Swiss domestic market. Public opinion is generally favourable towards foreign investment. However, a takeover of a national champion—such as one of the large financial services companies, the former national telecoms monopolist, Swisscom, or possibly also some major industrial companies—would most likely be opposed by politicians, the business establishment and the electorate.

8

Sweden	Rank
Overall environment for private enterprise	11
Financing environment	18
Market opportunities	9
Legal and policy environment	10
Entrepreneurial environment	8

Sweden fares well overall in the ranking, scoring best for its entrepreneurial environment. The venture capital industry has gained in importance in recent years, especially for start-ups in information technology and other high-tech sectors, and M&A activity is vibrant.

Strengths: Bankruptcy proceedings are swift and there is a government mechanism to support companies that need to restructure due to financial difficulties. Further development of the financial sector is expected thanks to increased M&A activity, heightened interest in initial public offerings (IPOs), corporate bond and equity issuance, and stronger demand for bank lending from the private sector.

Weaknesses: Entrepreneurialism can be stifled by tax rates, which are among the highest in the world. Sweden still has a relatively low rate of start-ups compared with the EU average.

9

Belgium	Rank
Overall environment for private enterprise	15
Financing environment	2
Market opportunities	12
Legal and policy environment	17
Entrepreneurial environment	10

Belgium's biggest attraction for private equity firms is its excellent financing environment. The federal and regional governments are now giving priority to measures aimed at reducing the considerable administrative burdens associated with setting up a new business.

Strengths: Financing conditions and policies specifically aimed at attracting foreign investment will all remain of a high quality. The Brussels stock exchange is linked in with those of Amsterdam, Paris and Lisbon in Euronext, and steps are being taken to encourage smaller companies to list with the creation in May 2005 of Alternext.

Weaknesses: Belgium's legal and policy environment is ranked lower than many of its competitors, such as the Netherlands, Norway and Germany. Reasons for this include a relatively restrictive labour market and fairly high corporate tax rates. Social insurance costs are high as are costs of dismissal, so employers are not inclined to take on new employees until they are confident that they will be able to afford high labour costs and need them for a long time ahead.

10

Ireland	Rank
Overall environment for private enterprise	10
Financing environment	10
Market opportunities	22
Legal and policy environment	3
Entrepreneurial environment	12

Ireland shares many of the positive attributes of its neighbour, the UK. Most notably, it has an excellent legal and policy environment. Its open attitudes towards FDI are mirrored in its approach to private equity firms.

Strengths: Ireland's great openness to international trade and its participation in the EU's single market have helped to prise open previously sheltered markets. Consistency in policy over decades—in the 1950s Ireland was one of the first countries actively to seek foreign direct investment—and the professionalism of state agencies have been central to Ireland's recent success in attracting high levels of inward investment.

Weaknesses: Continuing progress in liberalising those sectors in which competitive market forces do not yet operate freely can be expected. But market opportunities are limited by the relatively small size of the economy, which means that Irish firms are mostly small or medium-sized.

11

Finland	Rank
Overall environment for private enterprise	6
Financing environment	14
Market opportunities	5
Legal and policy environment	9
Entrepreneurial environment	22

Finland performs well in three of the rankings categories: the overall environment for private enterprise; market opportunities; and the legal and policy environment. Despite this, Finland's private equity environment lags somewhat behind its Scandinavian competitors, Denmark and Sweden (though it does rank better than Norway), thanks to a rather unwelcoming entrepreneurial environment.

Strengths: The Finnish government's attitude to foreign investment is positive, with very few restrictions. The government has a mandate, when market conditions are right, to broaden the ownership base in holdings still retained by the state. Particular investment opportunities abound in electronic equipment, computers and mobile phones.

Weaknesses: The government's Entrepreneurship Policy Programme contains few concrete measures and major improvements are not expected as a result. Finland's labour market is characterised by low levels of labour mobility and a system of incentives that discourages labour market participation. Finland also faces a risk of industrial action, as evidenced by the strikes and lockouts that plagued the pulp and paper industry in 2005.

12

The Netherlands	Rank
Overall environment for private enterprise	8
Financing environment	8
Market opportunities	15
Legal and policy environment	12
Entrepreneurial environment	19

The Netherlands places in the middle of the European countries in the rankings. It scores most heavily for its overall environment for private enterprise and for its financing environment.

Strengths: The Netherlands has a strong international orientation and a liberal policy stance towards foreign investment. The financial sector is characterised by a well-capitalised banking system, a liquid equity market, a sound regulatory system, and good access for both domestic and foreign borrowers to the local capital market.

Weaknesses: The country scores less well for its entrepreneurial environment. The tax burden on individuals in the Netherlands has traditionally been one of the highest in Europe, although the government has sought to stimulate the economy and employment by broadening the tax base and reducing marginal rates.

13

Norway	Rank
Overall environment for private enterprise	11
Financing environment	16
Market opportunities	11
Legal and policy environment	14
Entrepreneurial environment	14

Norway is the lowest ranked Scandinavian economy. It scores moderately well in all five rankings categories, meaning that while its business environment offers few significant advantages to private equity firms, equally, it holds few significant drawbacks.

Strengths: Despite often-stringent government controls, conditions for operating businesses in Norway are stable. Contractual arrangements are secure, with a solid legal basis, although the degree of protectionism afforded to domestic Norwegian companies will inhibit foreign investment more than in neighbouring countries.

Weaknesses: In terms of stockmarket financing, the potential disadvantage of having a relatively small bourse in Oslo is somewhat overcome by being party to pan-Nordic co-operation through membership of the NOREX alliance. Pension funds face restrictions on their investment in private equity.

14

Israel	Rank
Overall environment for private enterprise	23
Financing environment	22
Market opportunities	14
Legal and policy environment	6
Entrepreneurial environment	7

Israel is the highest ranking non-OECD country in the survey. The development of the venture capital industry in particular has been the most impressive and, arguably, one of the most important achievements in the country's financial sector over the last decade.

Strengths: The government kick-started the industry into life by creating Yozma, a state-owned VC fund that, using government seed money as a basis for starting other venture-capital funds, succeeded in developing a group of funds which have expanded into a multi-billion dollar industry. Due to such governmental commitment, the legal and policy environment is Israel's principal advantage. In particular, it scores impressively for its attitude towards foreign investment and the fairness of its tax system. Israel's entrepreneurial environment also ranks highly.

Weaknesses: Political uncertainty and the economy's relatively small size place constraints on market opportunities. Although Israel's policing of IPR infringements has generally improved, there are certain areas where Israel's performance remains weak. In May 2005 the US put Israel back on its priority watchlist of countries violating IPRs after a two-year respite following Israeli promises to enact legislation to protect intellectual property.

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15

Germany	Rank
Overall environment for private enterprise	13
Financing environment	9
Market opportunities	18
Legal and policy environment	11
Entrepreneurial environment	24

Considering it is Europe's economic powerhouse, Germany performs badly in the ranking. It is one of the lower-ranked West European countries—only Austria, Italy, Portugal, Spain and France fare worse. By and large the business climate is welcoming to foreign investment but suspicion of private equity remains: witness the public condemnation of foreign "locusts" by a prominent politician in 2005.

Strengths: Germany is a rich and comparatively open economy with sophisticated and attractive markets. Germany's generally highly skilled workforce and strong infrastructure make it a good location for specialised manufacturing. More generally, the structure of German industry is still relatively fragmented, providing foreign investors with the opportunity to participate in sectoral consolidation and to reap economies of scale through acquisitions.

Weaknesses: Low rates of economic growth and restrictions on hostile takeovers limit growth opportunities. Economic activity continues to be hampered by red tape, high labour costs and rigid employment protection legislation. Germany's decent financing environment may also work against the development of a local private equity industry. Bank credit, relatively inexpensive and available at long maturities, remains the most popular source of corporate funds. Pension funds are underdeveloped, for now.

16

Austria	Rank
Overall environment for private enterprise	16
Financing environment	17
Market opportunities	21
Legal and policy environment	16
Entrepreneurial environment	11

Compared with other Western European countries, Austria performs relatively badly in the quality of its private equity environment. The government has also taken steps to liberalise sheltered sectors of the economy, privatise and slim down the public sector, and encourage entrepreneurship, although the pace of reform in some areas is slow.

Strengths: Austria's economy is stable and Austria scores well on a number of important investment criteria: it has a high degree of legal security, a good labour relations record, an advanced education system, and strong links between university and company R&D departments.

Weaknesses: Some institutional investors are limited in what they can invest in private equity; because of the structure of the Austrian economy, there are fewer large firms than in other economies of similar levels of development and size, limiting buyout potential; and unduly restrictive regulations and high administration costs continue to impair competition in a number of markets.

17

France	Rank
Overall environment for private enterprise	13
Financing environment	13
Market opportunities	6
Legal and policy environment	18
Entrepreneurial environment	25

France ranks disappointingly. At 17th, it falls below most of its West European competitors, beating only Portugal, Spain and Italy. The French state continues to play a more prominent role than many other EU countries in trying to shape M&A activity, particularly in sectors of strategic interest to the government.

Strengths: The French economy is large and stable. It has a well-developed industrial base and one of the most productive workforces in the world. Euronext, a single trading platform linking the Paris, Amsterdam, Brussels and Lisbon bourses, has functioned well since it was established in 2000. Following the government's reform of the pension system in 2003, private pension funds are set to grow in importance but they remain small for now.

Weaknesses: The government's attitude to foreign investment is unpredictable. The habit of pursuing an industrial policy centred on the active promotion of "national champions" has persisted under governments of both left and right and will continue to do so. In terms of its entrepreneurial environment, public financing schemes and incentives for early-stage companies are relatively undeveloped.

18

Portugal	Rank
Overall environment for private enterprise	18
Financing environment	19
Market opportunities	28
Legal and policy environment	19
Entrepreneurial environment	9

Poor market opportunities are Portugal's biggest drawback. Despite this, with GDP per head standing at around just 70% of the EU average, Portugal's long-term growth potential is still higher than that of most of its European neighbours.

Strengths: Since the Portuguese exchange joined Euronext in March 2002, many Portuguese companies now listed in Euronext's two market indices are able to access a more liquid and competitive marketplace for share trading. And the entrepreneurial environment has potential, thanks to generous fiscal incentives for R&D spending.

Weaknesses: The country's small and fairly stable population of just over 10m limits the absolute size of the market. Its peripheral geographical location increases logistical costs. And Portugal's workforce had the lowest educational attainment levels in the original EU15 and still performs poorly even after the expansion of the EU.

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19

Poland	Rank
Overall environment for private enterprise	25
Financing environment	15
Market opportunities	20
Legal and policy environment	20
Entrepreneurial environment	17

Poland has the highest ranking of the Central and East European economies surveyed. Changes in such areas as speeding up business registration procedures and reducing the burden of official inspections should make a significant contribution to further improving the climate for business.

Strengths: Poland gets its best score for its financing environment, and, in particular, for the level of IPO activity, as a result of several large public offerings of flagship state companies and a growing number of private companies seeking to raise funds for expansion.

Weaknesses: Poland fares worst for the overall environment for private enterprise. This is partly down to relatively low marks for its bureaucracy although things are changing for the better. New laws governing competition and consumer protection are being introduced, in line with EU standards.

20

Republic of Korea	Rank
Overall environment for private enterprise	20
Financing environment	25
Market opportunities	8
Legal and policy environment	23
Entrepreneurial environment	15

The Republic of Korea is the top-scoring Asian country in the ranking, primarily because of the market opportunities it offers. In other respects, however, Korea underperforms. Attitudes to foreign investors remain wary, despite significant strides over the past decade.

Strengths: Opportunities derive from decent economic growth, based on vigorous domestic demand, and highly-developed IT and telecoms industries. The high technical skills of the workforce and good quality management also add to the country's appeal.

Weaknesses: Compared with many other economies, the quality and stability of its financial regulatory system are somewhat lacking. In the financial sector especially, there will be moves to ensure that local rather than foreign buyers prevail in the remaining reprivatisations. Such steps may include official encouragement to create local equity funds to compete with overseas buyout specialists.

21

Spain	Rank
Overall environment for private enterprise	17
Financing environment	20
Market opportunities	19
Legal and policy environment	21
Entrepreneurial environment	27

Spain underperforms in all categories, and particularly for its entrepreneurial environment. Venture capital funding for technology start-ups has not taken off and requires the development of a different financial and management culture. Harsh insolvency legislation can also deter risk takers.

Strengths: Spain's assets include its economic openness, policy towards foreign investment and the quality of its financial markets. Spain's capital markets underwent a major transformation during the 1990s equity boom, spurred on by a big privatisation programme, and Madrid is now the fifth-largest stockmarket in the EU in absolute terms.

Weaknesses: New medium- and long-term financing can be difficult to obtain in Spain. Compared with many other European economies, the restrictions on private equity investment are tight. Labour laws remain restrictive and productivity growth is among the lowest in the developed world. As for taxes, while rates on personal income and capital gains have come down significantly in recent years, the corporate tax regime is not competitive.

22

Hungary	Rank
Overall environment for private enterprise	18
Financing environment	27
Market opportunities	24
Legal and policy environment	8
Entrepreneurial environment	31

Of the Central and East European economies in the ranking, Hungary fares better than Slovakia, Czech Republic and Russia, but scores behind Poland. A major programme of consolidation, privatisation and restructuring has made Hungary's banking sector the most advanced in the region. The non-bank financial sector still plays a relatively limited role, however.

Strengths: The country's principal advantages for private equity firms lie in its developed legal and policy environment. The policy of selling state-owned firms to largely Western strategic investors has contributed to better corporate governance, faster company restructuring and a strengthening of the banking system.

Weaknesses: Market opportunities are rather low: there is little expectation of heightened M&A activity to meet the challenge of the EU single market, as most Hungarian firms prepared for such pressures ahead of EU accession.

23

Japan	Rank
Overall environment for private enterprise	20
Financing environment	6
Market opportunities	13
Legal and policy environment	30
Entrepreneurial environment	32

Despite its size and wealth—Japan boasts the world's second-largest economy—the country performs poorly in the ranking. Japanese business practices continue to act as an invisible barrier for many foreign companies. And entrepreneurs face considerable bureaucratic and cultural hurdles in seeking to break the mould.

Strengths: Changing corporate attitudes, particularly towards M&A activity, help to buoy Japan's market opportunities score. In 2004 there were 2,200 M&A deals in Japan, an increase of some 30% year on year. M&A activity will probably be boosted in 2007 when revisions to the Commercial Code allow foreign companies to use equity swaps as a means of taking over Japanese companies.

Weaknesses: The so-called trade associations or cartels maintain tight control over whole sectors, both to ensure that prices remain higher than market forces might dictate and to guard against outside interlopers. Private equity activity has also been dampened by an increase in transaction costs, following the introduction of a new withholding tax that targets foreign buyout firms.

24

Italy	Rank
Overall environment for private enterprise	26
Financing environment	21
Market opportunities	25
Legal and policy environment	24
Entrepreneurial environment	26

Italy, the lowest-ranked West European country, fares badly across the board. Limited liberalisation, restrictions on private equity investment in pension funds and restrictive labour laws all help make Italy an unappealing environment for private equity.

Strengths: Aside from the size of the economy and the stable regulatory environment, Italy's appeal lies in the potential for industrial restructuring. Liberalisation has been under way in most sectors of the economy since the second half of the 1990s. Liberalisation of public utilities, notably the provision of telecommunications services and energy, should continue.

Weaknesses: The country's complex bureaucratic and legal procedures and inadequate infrastructure continue to deter investors. The overall tax burden on firms is also high, and the labour market is still rigid, despite reforms to encourage the use of more flexible employment contracts. Italy's bankruptcy law is focused on punishing insolvent entrepreneurs rather than saving struggling firms. The dominance of the state-run pay-as-you-go pension system has restricted the growth of private pension funds and their role as institutional investors.

25

Slovakia	Rank
Overall environment for private enterprise	24
Financing environment	30
Market opportunities	27
Legal and policy environment	22
Entrepreneurial environment	18

Slovakia ranks just ahead of its neighbour, the Czech Republic, but below Poland and Hungary. The country's biggest handicap is its financing environment.

Strengths: There have been marked improvements in many areas over the past few years. Privatisation of the financial and energy sector has been completed, and EU laws liberalising energy and telecommunications markets have been adopted. Reform of the judiciary and bankruptcy laws will improve law enforcement, one of the main weaknesses of the business environment.

Weaknesses: There is no legal fund structure for private equity firms in Slovakia and virtually no demand for domestic listings. However, the privatisation of the banking sector has ended the widespread soft lending practices of the past and will increase competition on the credit market. This will eventually force some Slovak companies without foreign capital into bankruptcy, fostering corporate restructuring.

26

Czech Republic	Rank
Overall environment for private enterprise	22
Financing environment	23
Market opportunities	23
Legal and policy environment	28
Entrepreneurial environment	33

Czech Republic's relatively poor showing compared with its neighbours—it ranks lower than Poland, Hungary and Slovakia—can mainly be attributed to its unfavourable entrepreneurial environment. Attitudes towards private equity—both culturally and legislatively—can be hostile.

Strengths: Attitudes towards foreign investment are welcoming. During the first half of 2005 over 70 foreign firms decided to invest in the Czech Republic, committing to US$1bn in new investments that are expected to create 8,000 new jobs. Banking privatisation has placed 95% of all solvent bank assets in foreign hands.

Weaknesses: The bureaucratic requirements for starting a company are onerous and the legal framework for bankruptcies has been repeatedly criticised by the World Bank for providing limited power for creditors, resulting in lengthy court administration of bankruptcies or restructuring, and being slow in clearing bankrupt companies from the market. Capital markets are not well developed and are stymied by a weak regulatory framework. The labour code is widely criticised for being inflexible.

27

Greece	Rank
Overall environment for private enterprise	27
Financing environment	24
Market opportunities	26
Legal and policy environment	25
Entrepreneurial environment	30

Greece is the lowest ranked EU country. Doing business in Greece can be fraught with bureaucratic pitfalls. Laws are often confusing and ambiguous. EU directives have at times been incorporated into Greek law without first repealing the previous national legislation, creating legal contradictions.

Strengths: The country's membership of the EU and euro area provides assurance of comparative economic and regulatory stability. The government is pushing through a variety of initiatives aimed at attracting currently limited volumes of foreign investment.

Weaknesses: There is some residual opposition to foreign companies taking majority stakes or assuming management rights in traditionally Greek firms. The serious shortage of skilled labour in services and IT reflects weaknesses in the state education system and vocational training programmes, which fail to produce workers with the required skills mix. There is currently no provision for private pensions.

28

Turkey	Rank
Overall environment for private enterprise	28
Financing environment	33
Market opportunities	29
Legal and policy environment	29
Entrepreneurial environment	16

Turkey ranks poorly in most categories, and the worst of any country for its financing environment. The banking sector is being overhauled but it has yet to be proved in practice that the entire banking system is capable of standing up to a major shock or that individual banks are being monitored sufficiently closely to prevent further surprises.

Strengths: Turkey's long-term potential is its greatest asset, given the size of its population, its low income per head, and the prospect of eventual EU membership. Demand could grow particularly rapidly for goods and services aimed at specific, dynamic market segments, such as single and small households and the newly urbanising classes.

Weaknesses: The financing environment is not the only drawback for private equity firms. Deterrents to investment will continue to include political and macroeconomic instability, as well as general problems of the business environment such as corruption, red tape, incomplete enforcement of intellectual property rights, the slowness and unpredictability of the judiciary and difficulties in finding suitable land.

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Brazil	Rank
Overall environment for private enterprise	29
Financing environment	31
Market opportunities	31
Legal and policy environment	31
Entrepreneurial environment	21

Brazil scores poorly in the private equity rankings, although the market is growing. The three largest pension funds in Brazil—run by the state oil company, Petrobras; the state development bank, BNDES; and one of the few remaining state banks, Banco do Brasil—increased their participation in private equity funds from close to zero in 2004 to around 1% in early 2005, to reach over R610m.

Strengths: Long-term opportunities are alluring. As the second generation of the founders of the companies created during the period of rapid industrialisation in the 1940s to 1960s look for successors, they are turning increasingly to professional management rather than family members.

Weaknesses: Seed finance is scarce and entrepreneurs often rely on "angel" investors or less structured forms of financing for capital. Despite progress over the past ten years, educational and skill levels for most of the labour force are very low. Brazil's systems of corporate and indirect taxation are widely regarded as excessively complex, porous and inefficient.

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Russia	Rank
Overall environment for private enterprise	33
Financing environment	32
Market opportunities	4
Legal and policy environment	32
Entrepreneurial environment	23

Russia ranks poorly, despite its size, growth and buoyant M&A activity. The overall business environment leaves much to be desired. On issues such as red tape, protection of intellectual property and competition policy, Russia trails OECD countries.

Strengths: The attractions of the Russian economy will remain strong, including a large and fast-growing consumer market, massive oil and gas resources, a low-cost and highly skilled labour force, and continued macro-economic and political stability. Scope for industrial restructuring is enormous but the processes of liberalisation and deregulation are halting and often non-transparent.

Weaknesses: Foreign investors are faced with numerous obstacles, such as predatory officials, shareholder abuse and rigged privatisations and licensing. Non-bank finance remains underdeveloped, while banking reform in Russia still lags behind reforms in other sectors. Medium-term financing in Russia is rare, and long-term financing even more so. By far the largest source of finance for capital investment is retained earnings. Additionally, the court system is still a poor mechanism for protecting shareholder rights and many court decisions are never enforced.

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Mexico	Rank
Overall environment for private enterprise	31
Financing environment	28
Market opportunities	32
Legal and policy environment	27
Entrepreneurial environment	20

Mexico is the lowest-ranked OECD country and third lowest-ranked country overall. Non-bank sources of capital are only weakly developed. Private equity firms remain of only limited importance, and tight restrictions on investment allocation by private pension funds remain in place.

Strengths: An open foreign-investment regime—and in particular the implementation of the North American Free-Trade Agreement (NAFTA)—has brought considerable changes to Mexico's corporate landscape during the past decade.

Weaknesses: The tax system is convoluted and characterised by widespread evasion, labour market regulations are complex and inflexible, and private enterprise is hindered by weak competition policy, vested interests, and reluctance to liberalise important areas of the economy.

32

India	Rank
Overall environment for private enterprise	30
Financing environment	29
Market opportunities	33
Legal and policy environment	26
Entrepreneurial environment	28

India has the second worst environment for private equity of the countries surveyed. Although the Indian government is gradually deregulating, red tape abounds.

Strengths: India's large pool of inexpensive and skilled labour has helped create strong export-driven services sectors in information technology (IT) and business process outsourcing. India's domestic market is becoming important in its own right, too. The country's population of more than 1bn people is the main attraction: the recent surge in car sales demonstrates the increasing purchasing power of India's urban middle class.

Weaknesses: Setting up a new business can be a slow and difficult process. The restrictiveness of Indian labour laws remains a major deterrent to investment. There are also strict controls on foreign investment.

33

China	Rank
Overall environment for private enterprise	32
Financing environment	26
Market opportunities	30
Legal and policy environment	33
Entrepreneurial environment	29

The world may be rushing to invest in China, but its environment for private equity is the most challenging of any country in the ranking. For international firms, entering the Chinese market as a foreign company can be an extremely challenging process and generally involves protracted negotiations.

Strengths: China's long-term appeal is obvious. China's large and rapidly growing economy is liberalising fast. A wide range of state-owned companies will be looking for strategic foreign investors in the coming years. Despite the size of the market, however, opportunities are limited by underdeveloped management quality and a relatively restricted supply of high-end labour.

Weaknesses: Due diligence and valuation processes are often hampered by an absence of verifiable data. Legislation governing foreign investment can be bewildering and arbitrary, especially as authorities toy with new regulations. China also scores badly when it comes to corruption and the strength of its judicial system.

Rankings methodology

Both the individual ranking criteria and the categories are weighted neutrally in the model. Quantitative data are taken from Economist Intelligence Unit databases, with the exception of data on M&A activity and IPO activity, which are taken from Zephyr. Qualitative data were scored for this report by Economist Intelligence Unit analysts.

The scores in the ranking are z-scores. This is a statistical device used to measure the distance from the mean average. A country with a positive score is above the mean; a negative scoring country is below the mean.

Overall environment for private enterprise

- Protection of private property rights
- Freedom of existing businesses to compete
- Impact of state control on business environment
- Protection of intellectual property
- Red tape and bureaucracy
- Competition policy
- Corruption
- Strength of judicial system

Financing environment

- Financing depth: Stockmarket capitalisation
- Quality and stability of overall financial regulatory system
- Availability of long-term sources of capital
- Interest rates
- Long-term bond yields
- Demand for local IPOs
- Restrictions on institutional investors investing in VC/PE

Market opportunities

- GDP
- Quality of management
- Scope for consolidation
- Technical skills of workforce

Legal and policy environment

- Openness of national culture towards private equity
- Government attitudes to private equity
- Laws on VC/PE fund formation and operation
- Degree of restrictiveness of labour laws on hiring and firing
- M&A and takeover regulation
- Quality of local accounting regimes
- Quality of corporate governance regimes
- Government policy towards foreign investment
- Consistency and fairness of overall tax system
- Corporate tax rates
- Tax treatment of VC/PE funds & investments

Entrepreneurial environment

- Cultural attitudes towards entrepreneurs
- Personal income tax rates
- Public financing for early-stage companies
- Capital gains tax for individuals
- Fiscal incentives for R&D
- Bankruptcy and insolvency legislation
- Government regulation on setting up new business

4
THE CHALLENGE OF VALUE CREATION

Opportunities to make money from financial engineering and arbitrage are diminishing

Value creation through active ownership is the most reliable way to deliver superior returns

The best firms are scaling up and digging deeper into targeted industries, although there is still a place for niche players

Traditionally, there have been three trusted routes for buyout firms to make money. The first model was based on arbitrage. Private equity firms could acquire an asset cheaply at the bottom of the cycle and sell at the top of the market, or buy an underpriced asset in an opaque private market, where its true value was obscured, and sell at a higher price by taking the company public. Alternatively, they could deploy clever financial engineering—in particular, debt leverage—to squeeze value out of an investment.

Those opportunities have largely, but not entirely, evaporated. Excess liquidity resulting from rapid growth in money and credit has pushed asset prices up and increased leverage multiples: in 2005, buyout firms were borrowing an average of 5.5 times the target company's earnings before interest, tax, depreciation and amortisation, up from 4.5 times in 2004. Auctions have generally replaced proprietary buyouts (inflating the sale price of a buyout target and reducing the arbitrage potential) and debt instruments are mundane banking products. Since all buyout firms' debt packages are essentially equal, the winner will be a firm that is prepared to accept lower returns than other bidders, or that has a unique value-creating strategy.

These days, the primary model for value creation after a buyout is the third model of active ownership. Under this model, portfolio companies are painstakingly analysed and supervised, from before the transaction until the eventual exit. Value is created by sweating the details, with no lazy production manager or surplus company car safe from the attention of the buyout firm.

Research by McKinsey & Company reinforces the importance of active ownership.[21] In a study of over 50 buyout deals by eleven leading private equity firms, McKinsey found that company outperformance had been the primary source of value creation in 63% of all cases. Market or sector appreciation, plus financial leverage, accounted for a further 32%, with just 5% attributed to pure arbitrage. McKinsey also noted that in the deals where value had mainly been generated by performance, the best returns had been achieved in cases where private equity partners had devoted at least half their time to the company during the hundred days following an acquisition. This time was typically spent on some of the thorniest management issues. For instance, McKinsey discovered that in 83% of the best performing deals, private equity firms had strengthened the management team at an early stage of investment.

In the age of active private equity ownership, there is no substitute for deep knowledge of specific industries. Private equity firms that specialise in specific sectors give themselves the best chance of delivering promised returns to fund partners. By contrast, firms that spread themselves too thin run two risks. First, they may lack the expertise to spot assets with substantial scope for improvement and growth, and in some cases, to see how separate assets in the same market could be combined to add value. Some industry professionals also contend that buyout firms with entrenched sectoral teams have better access to inside information about potential targets. Second, they may not have the necessary industry expertise to improve performance following a deal.

Healthcare is a good example of a sector whose potential only those buyout firms with deep industry expertise will capitalise on. Anyone can grasp that rising life expectancy in the developed world will bring increasing demand for such services as long-term care homes for the elderly. But it takes considerable time and analysis to master an industry landscape that is both highly regulated and fragmented.

Similarly, deep industry knowledge is needed to understand and anticipate the complex dynamics of the telecoms sector, from falling fixed-line revenues and saturating mobile markets to increased income from data transmission and the opportunities and threats posed by cable and satellite.

21. McKinsey Quarterly 2005, No.1. Joachim Heel and Conor Kehoe: "Why some private equity firms do better than others."

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Rivals or allies? The rise of new industry players

The biggest and potentially most profitable buyout deals are generally won by consortia or "clubs" of private equity firms, for the simple reason that none of them individually has the resources at present to pursue multi-billion dollar opportunities. Industry executives believe that within the next five years, the top private equity firms will be able to raise funds in excess of $20bn. But until then, these global players have to form alliances with competitors in order to win the most valuable prizes. These alliances include partnerships with hedge funds and banks.

Hedge funds have moved rapidly into private equity in recent years, drawn by the sector's high returns and growing liquidity, and by diminishing returns in their traditional business. In the past two years, hedge fund groups have made bids for such leading firms as the discount retailer Peacock in the UK and for Toys "R" Us, the energy group Texas Genco, and the consumer electronics retailer Circuit City in the US. Some investment market observers believe it is only a matter of time before hedge funds become major private equity players in their own right.

This is debatable. The key issue is whether hedge funds have the patience or post-deal operating skills to add long-term value to buyout investments. True, the number of hedge funds willing to play a long game looks set to rise, partly because of pressure from America's Security and Exchange Commission. In February 2006, a new ruling required US hedge fund managers (who dominate the industry) to register with the SEC, unless their lock-ins for investors exceed two years. But hedge funds, with their analytical and arbitrage skills, are arguably better adapted to bidding for assets than the long, hard slog that follows. Indeed, some private equity executives, while acknowledging that hedge funds could be a future competitive threat, believe they are potentially desirable partners for buyout firms in auctions precisely because they bring this type of expertise to the table.

The future role of banks in private equity fundraising and investment is also unclear. To be sure, their presence looms large. Goldman Sachs is ranked by the research group Thomson as the world's biggest private equity firm, with US$35.88bn in private equity capital under management in September 2005. Goldman Sachs and other investment banks are regular participants in the biggest buyout auctions, either in club deals with traditional private equity firms or as independent bidders. Their ability to compete in LBOs is enhanced by the wide range of products they can offer the buyout target, such as debt financing, and their large network of contacts.

Many investment banks are still unsure about the desirability of in-house private equity divisions. It is not difficult to see the questions that might lead to such a decision. What happens, for instance, if a bank finds itself bidding in an auction against a trade buyer who happens to be a client? How can a bank remunerate its best private equity executives at the same level as their peers in the buyout industry, given that it needs to take its share of the profits?

On the other hand, the agency and advisory sides of investment banking make an increasingly insignificant contribution to the bottom line of most global players as margins are squeezed by competition and rising IT and regulatory costs. The bulk of their income comes from their own balance sheet. From this perspective, a profitable private equity division is a valuable in-house asset, given the sector's outstanding growth prospects. In the first nine months of 2005, private equity deals accounted for 19% of all investment banking revenues (worth US$44.4bn), according to the research firm Dealogic.

For traditional private equity firms, the question is whether these new players represent competitive threats or potential business allies. And in a market where today's club deal partner is tomorrow's auction rival, the answer is almost certainly both.

Size counts

To achieve this level of commitment, private equity firms need substantial resources. The effort of knocking portfolio companies into shape involves a heavy drain on manpower and back-office expertise. Time used to recruit a new chief executive or review a fresh business plan is time that cannot be spent exploring other buyout deals. Global buyout firms will need large sector teams—sometimes running into dozens of partners—in order to achieve strong industry coverage. That is one more reason why it will pay to have scale in tomorrow's buyout market.

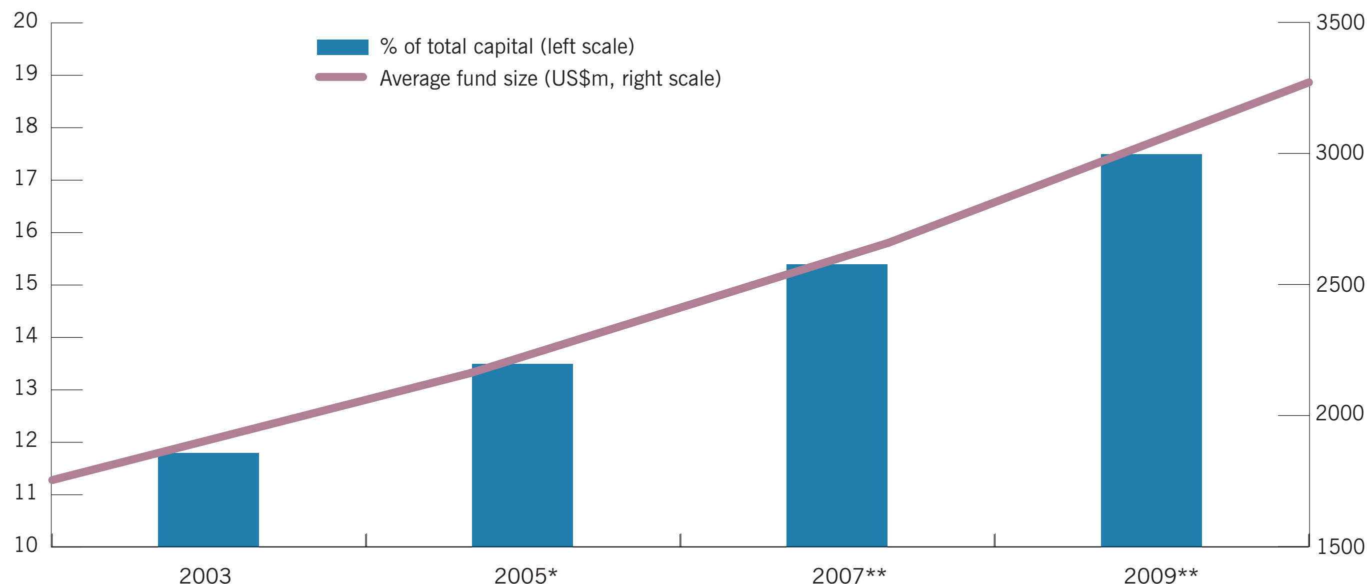
A scale game implies that smaller players are the losers. The reality, however, is more complex, especially as the industry penetrates new global markets. It is possible to thrive outside the bulge bracket, provided a buyout firm corners a particular market. There is still plenty of room for niche players, particularly in developing countries, where a local buyout shop specialising in Polish industrial restructuring deals, say, or underperforming South Korean supermarkets can sometimes trump international competitors.

A good example is India's nascent buyout market, where domestic players with contacts in the country's labyrinthine bureaucracy are well-placed to steal a march on bigger international private equity firms when state assets come up for auction. Similarly, some of India's returning band of high-tech entrepreneurs, having made their fortune in Silicon Valley, are setting up venture capital and buyout firms that combine local knowledge with world-class technology and telecoms expertise.

Nor does the importance of scale mean the end to strong ties between the buyout and venture capital wings of the industry. Buyout firms forego the opportunity to cultivate useful relationships and deepen sectoral understanding if they focus only on more established players. In the ideal scenario, today's US$10m-a-year

Bulging bracket

Capital under management at the top ten firms



* Year to June 2005; ** Based on current rates of growth
Source: Thomson Venture Economics / NVCA (for US Venture Capital data), Economist Intelligence Unit

start-up, nurtured by a venture capital firm, becomes tomorrow's US$100m-a-year fledgling, under the wing of a specialist growth financier. In time, it could become a US$500m-a-year heavyweight, acquired by a buyout firm with a view to doubling its revenues again.

Larger firms will tend towards large deals in order to deploy their resources most efficiently. Smaller firms will do smaller deals where, with the right strategy, higher returns should be attainable. It is those buyout firms that are caught in the middle—neither large enough to compete with the bulge bracket, nor small enough to have the agility and local contacts of niche players—that are feeling the squeeze. In this respect, the trajectory of the private equity industry is beginning to resemble the evolution of other sectors that have globalised in the past two decades, such as management consultancy and investment banking in the 1980s and advertising in the 1990s.

Private equity faces the future

The prospects for the private equity industry have never been better. Five years from now, the sources of buyout capital will have deepened and widened. Investment opportunities will also have gradually expanded, as more buyout possibilities emerge in continental Europe in particular and as the large buyout firms push into the S&P large-cap market. And the top private equity firms will have the management strength and financial scale to withstand most market downturns.

This leading group now operates in a world where multinational, multi-billion dollar deals are commonplace, and where major acquisitions require detailed, expert supervision. In response, the leading players are taking on the attributes of global corporations, with branches in every important investment hub from New York to Hong Kong. They are staffed by a phalanx of accountants, compliance teams, and other members of a substantial and growing back office.

This is not a matter for regret. In the 1970s and 1980s, the best private equity firms needed the charisma and leadership skills of the founding partners to nurture an industry that was still little understood beyond a limited number of sophisticated investors. But in a world of multibillion dollar funds and multinational buyout deals, a leading group of private equity firms—exploiting global scale, deep sectoral expertise, a professionalised back office and an international brand—has the greatest chance of delivering the superior returns that investors demand. These firms are best-placed to deliver private equity's next great wave of growth and to lead the industry forward to rival the public markets in size.

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