A two-speed industry

How do private equity investors create value?

A study of 2015 European exits

EY
Building a better working world

Contents

Executive summary

This is the 11th in our series of studies examining how European private equity (PE) investors create value in their portfolio companies. Over more than a decade, our studies have tracked PE activity, the industry's value creation record and key trends. Our findings have consistently demonstrated PE's ability to generate outperformance through strategic and operational improvement in the companies it backs through both good and more challenging times. Set against a backdrop of record exit numbers and values, this year's research hones in on one of the key determinants of success for PE investments — length of holding period — and demonstrates the value of agility and importance of consistent activity levels to PE firms' long-term health.

After a strong 2014, last year was a record-breaking year for PE exits in Europe. There were 121 exits from the portfolio during 2015, far surpassing even the peak years of 2006 and 2007 and the value of exits also matched the previous all-time high recorded in 2014. These exits were achieved across all three main routes of trade sales, IPOs and secondary buy-outs, reflecting a confidence in the broader market environment but also showing PE's ability to identify realization opportunities across the board. Sales to corporate buyers were particularly strong, providing another record-breaking statistic, with 48 portfolio companies exited this way, substantially higher than the previous peak of 36 in 2011.

Last year also marked the first period since the downturn that exit activity by value reached 20% of the portfolio value, a rate that is consistent with a five-year hold. Given the inverse relationship between length of hold and gross return to investors, particularly for the element of return that is PE outperformance, our analysis suggests this benchmark is a sign of a return to a healthy industry. At the same time, new investment activity continued to increase, with PE deals in 2015 reaching a post-crisis high in Europe, and catching up on exit activity so that an end to the decline in portfolio value witnessed since 2008 may now be in sight.

While this is clearly good news, our study also points to the continued exit overhang in the portfolio: the portfolio age remains high in 2015, at 4.5 years, signposting the backlog of realizations from the portfolio stemming from the low exit levels in the years following the crisis. In addition, the average length of hold (i.e., from initial investment to exit) of portfolio companies exited in 2015 was also high, at 6.2 years, well above the 3.5 years of companies exited in 2007. As limited partners already know, the lag in exits will reduce realized returns from European PE over the medium term.

Executive summary

For this year's study, we set out to determine if there are areas of European PE that are performing better or worse than others. We found no material differences by sector, by country and by deal type. In addition, we confirmed that a recovery in large deal activity seen in 2014 and 2015 makes deal size a less significant factor.

However, when we looked at the PE industry split by age of portfolio, we found evidence of a two-speed industry. We grouped general partners (GPs) according to the average age of their portfolio companies: one group with an average portfolio age of 4.5 years or less (GPs with young portfolios); the other with an average portfolio age of greater than 4.5 years (GPs with old portfolios). Our analysis shows that GPs with young portfolios are far outstripping those with old portfolios in two key measures of health: the GPs' exit and investment rate.

Indeed, GPs with young portfolios have clearly managed to exit companies at a much faster rate than the other group, with exit activity measured by entry enterprise value (EV) as a percentage of the portfolio at the start of year running at 24% for the last two years, while GPs with old portfolios managed an average exit rate of only 14% in the same period.

The difference between the two groups becomes still more apparent when new investments are analyzed. While the GPs with young portfolios account for 60% of the total number of portfolio companies in the sample, they were responsible for 82% of new investments, leaving GPs with old portfolios making just 18% of new investments in 2015. This analysis shows a clear difference in activity rate between the two groups, resulting in a two-speed industry. This means that GPs with young portfolios are increasing their share of the overall European PE portfolio, while the other group is seeing its share decline over time.

Our study therefore implies that GPs able to add value to portfolio companies and exit in a timely manner are attracting further capital from limited partners (LPs) to enable new investments; by contrast, a slower exit pace for the other group means that they face challenges in raising fresh funds for deals. Pace of activity really does count in PE.

The overall picture is one of a slow but persistent shake out in the European PE industry with more agile and active PE firms providing attractive returns and therefore winning out, leaving those with old portfolios far behind. Given PE's long-term horizons, this consolidation will necessarily take several years to complete. However, the outcome will ultimately be a stronger European PE industry that continues to provide the outperformance that its investors require.

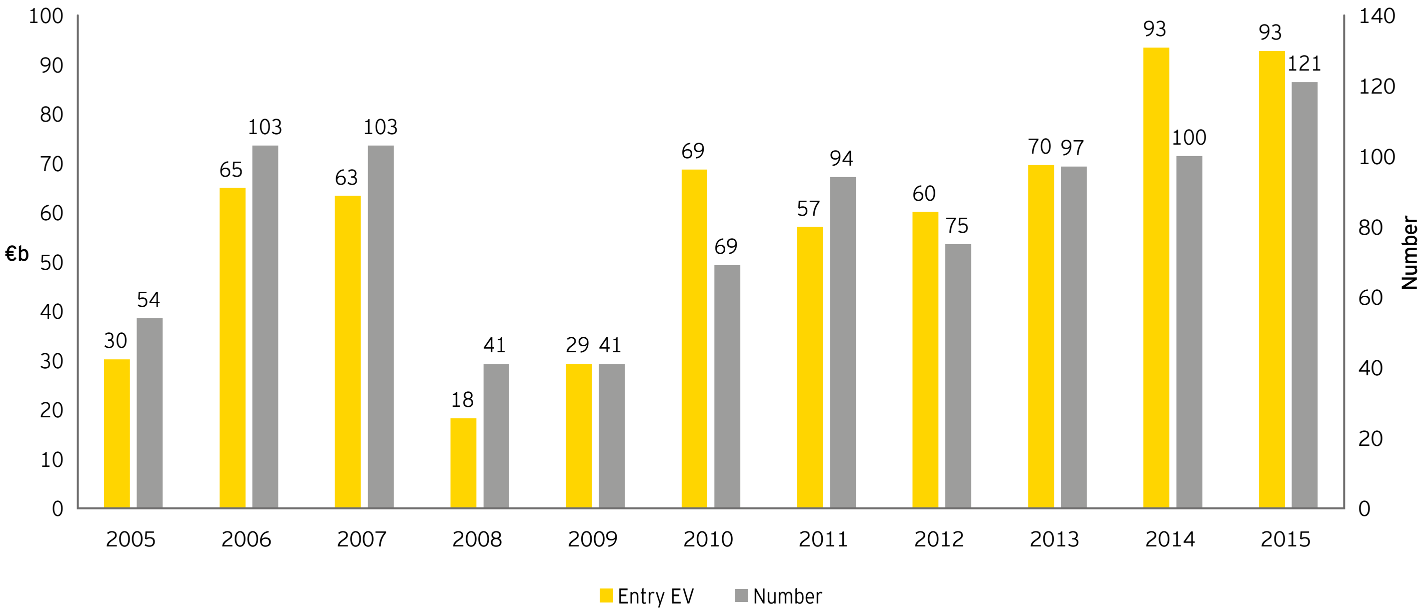
Key findings

Strong activity in 2015

European PE exit activity reached record highs in 2015, following on from a strong 2014. By number, there were 121 exits from our sample portfolio last year, a big pickup from 2014 and substantially more than the boom period of 2006 and 2007, which each saw 103 realizations.

The tally of exits by entry EV also matched the all-time high of €93b recorded in 2014. The figures from 2015 mark the third year of significant improvement in the number of exits and continued strong activity as measured by entry EV.

Figure 1. PE exits by entry EV and number, 2005-15



M&A exits at record high

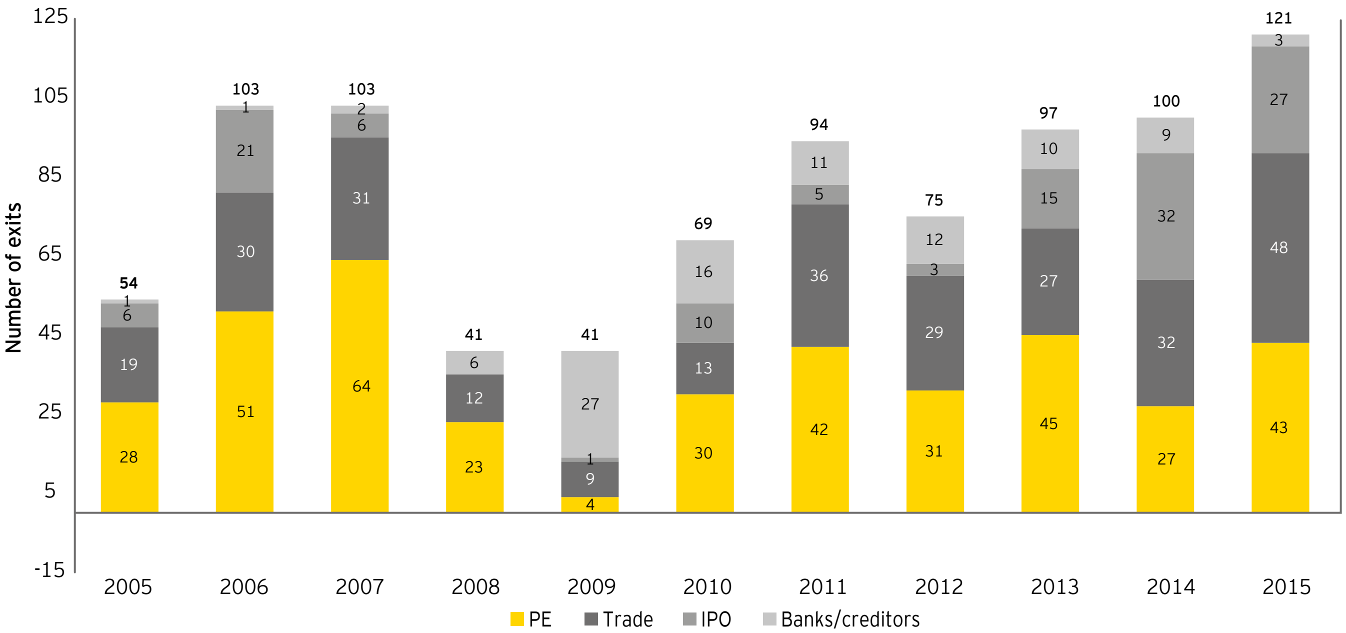
These exit figures are set against a backdrop of record M&A globally in 2015, high levels of dry powder among PE firms seeking to deploy capital and a strong IPO market relative to long-term historical levels. Europe's PE firms sought to benefit from this positive environment, achieving a good spread of exits across all three routes.

Worldwide M&A deal values totalled more than US$5t last year, according to Thomson Reuters data, surpassing the 2007 peak, as many companies pursued growth through acquisitions. European PE took advantage of the trend of confident corporate buyers, with exits via trade sales reaching an all-time high by number (48) in our portfolio. This comfortably beat the previous record of 36 trade sales in 2011 and was far higher than the 32 seen in 2014.

Sales to other PE houses were also at healthy levels. Secondary buyouts provided an exit route for 43 portfolio companies in 2015, reflecting the healthy fundraising environment seen over the last few years, plus the strong credit markets bolstered by the recent growth of private debt firms in Europe, many of which have focused on sponsored transactions.

In addition, the main third route, exits via IPO, had a relatively strong showing in 2015, with 27 companies in the portfolio listing on public markets, the second highest number recorded since our studies began. The number of IPOs is slightly lower than the 32 seen in 2014. However, this reflects the increased uncertainty in public markets in the second half of the year following the falls in China's stock markets in the summer of 2015. Creditor exits, meanwhile, fell to their lowest levels since before the crisis, with just three recorded in our portfolio in 2015.

Figure 2. PE exits by exit routes, 2005-15



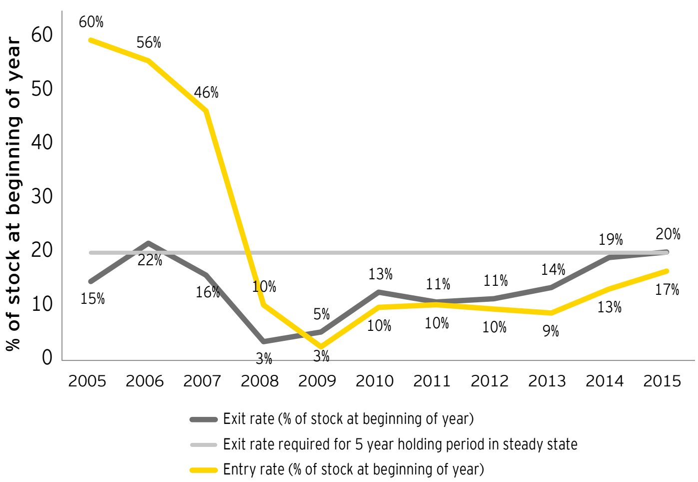
Healthy activity levels returning

The increase in realizations, when measured relative to the size of the PE portfolio, shows that European PE activity is moving towards the 20% level that marks a healthy industry, i.e., an average five-year holding period. The exit rate registered at 19% and 20% of the portfolio entry EV in 2014 and 2015, respectively — close to and spot on the target rate that implies an average five-year holding period. The last two years mark the first time European PE has achieved even close to the 20% mark since the downturn; the uptick in 2014-2015 follows several years of much lower activity rates.

New deal activity is also increasing. Three strong fundraising years (Europe-focused PE funds raised €233b in the 2013-2015 period, according to Preqin data, up from €148b across the three preceding years) provided ample funding for new deals. This was coupled with the higher levels of confidence in Europe's economic prospects that prevailed for much of last year. As a result, 2015 marked a post-downturn high for new investments.

There were 125 new deals added to the sample portfolio in 2015, higher than the 120 recorded in 2014, but still some way off the boom years of 2005 and 2006, when 184 and 197 new investments were made, respectively. The value of new investments was also high, with entry EV registering €76b, up from the €65b seen in 2014. When expressed as a percentage of the portfolio aggregate entry EV, the entry rate also increased last year, to 17%. This is up from 13% in 2014 and considerably higher than the 9% to 10% seen in the 2010-2013 period.

Fig 3. New investments and exits (entry EV as % of portfolio EV at start of the year)

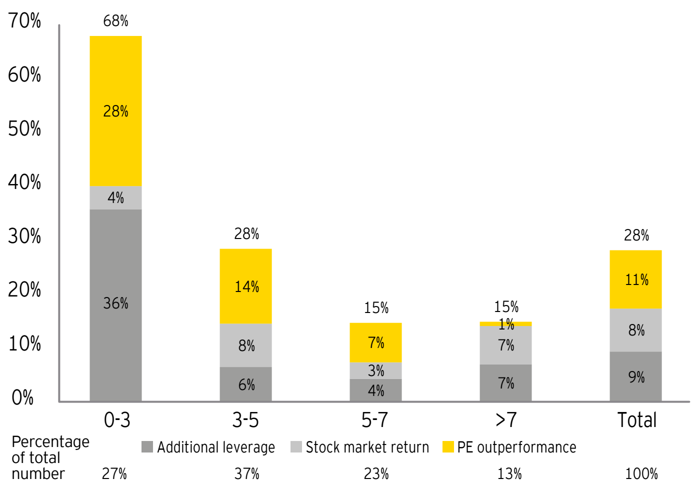


An exit rate of 20% marks a healthy industry, and the entry rate (relative to the exit rate) then indicates whether the industry is growing or declining. The gap between these two rates may have been low in the 2008-13 period, but overall activity was subdued. The growth in 2014 and 2015, however, shows a more promising trend, with strong exit rates and entry rates both moving in an upward direction and the gap between the two remaining narrow. Collectively, these indicators point towards an industry that is moving back to long-term health, and a possible halt to the decline of the portfolio (measured by aggregate entry EV) that has been in evidence since 2009.

Why does age matter?

One of the consistent findings in our studies is that gross returns generated by PE investors decline with length of holding period. The Internal Rate of Return (IRR) — the industry measure of performance that captures capital growth and timeframe — is evidently highest for businesses that have the shortest ownership periods and this accounts for just over a quarter 27% of exits in our sample. There is a steady decline in IRR as holding period lengthens, from 28% in four to five-year holds to 15% in those with holding periods of greater than five years. This reflects a greater amount of time required to improve business performance and valuation, or to find a new owner. As our analysis shows, the effect of PE outperformance (its ability to improve the performance and value of portfolio companies over and above public company benchmarks) reduces sharply over time, and this explains a large part of the decline in absolute returns with length of hold.

Figure 4. Gross IRR on PE exits by length of hold and source of gain





Exit overhang persists

Despite the record exit values and volumes in 2015 — and much healthier exit and entry rates — our analysis shows that there remains an exit overhang in the current portfolio. In all our studies since the crisis we have consistently reported this as an issue, as the low levels of exit activity seen between 2008 and 2013 created a backlog of realizations that has still to be fully worked through. The average age of businesses in the portfolio stands at 4.5 years (measured from the date of acquisition to the end of December 2015), the same as 2014 but still at the highest since our survey began. Likewise, the average length of hold for exits in 2015 was 6.2 years, just slightly shorter than the 6.3 years seen in 2014, which was the highest since our studies began (by way of comparison, the average age at exit was just 3.5 years in 2007).

Given the age of the current portfolio — and the number of old investments yet to be realized — the results of our analysis are consistent with the widely-held view that realized European PE returns will be held back as these old investments are exited. LPs are already well aware that the returns of some investments will dip and have largely priced this into their current valuations and return expectations.

Records won't be beaten in 2016

While 2015 saw welcome good news for European PE in terms of exits and new investments, the signs are that 2016 will not match last year's activity levels. Confidence in the global economy — and therefore in M&A activity — tailed off towards the end of 2015 and has failed to recover as 2016 has progressed. In the first half of 2016, European PE new investment values and volumes fell considerably and, as global M&A declined and public market volatility made IPOs more challenging, exit activity also reduced.

In addition, exit and investment figures may be affected during the second half of 2016 following the UK's EU referendum result, with business and investor confidence in Europe more broadly, and in the UK in particular, knocked by uncertainty around future political and economic direction.

A mixed picture

The overall picture that emerges from our headline results is mixed. On one hand, 2015 saw record exits from the PE portfolio, leading to a 20% exit rate, plus growth in new investment activity. Together these figures mark the most healthy activity levels since 2006. The year also registered strong support from LPs as fundraising values remained high, driven by a rise in distributions to LPs and a need for investors to generate returns in a persistently low interest rate environment. This suggests that the European PE industry is moving in a positive direction .

Yet on the other hand, our study points to parts of the portfolio that have been slow to exit, with an expectation of declining returns to investors, and the prospect of a reduction in exit and new investment activity in 2016 . The implication, therefore, is that conditions will not provide a tailwind for those firms needing to work through some of the legacy issues in their portfolios.

Presented with such a mixed picture when examining the whole portfolio, in this year's study we have zoomed in to analyze in closer detail which parts of the industry are performing better than others. To achieve this, we analyzed the data from our sample portfolio by industry sector, country, deal size and deal type, testing on the key measures of health: current portfolio age, exit and entry rate as well as value creation record. While there is some variation in performance by sector, country and deal type, there were no clear findings or persistent trends.

We had expected to see deal size as a key factor in performance. This is because returns are lowest for the largest deals (entry EV of more than €2b), and in terms of activity, the entry rates for the largest deals were by far the highest in the 2005-08 period, and exit rates by far the lowest in the period 2009-13. In other words, there was a large number of big deals completed in the run-up to the downturn, yet these were not exited within the four to five-year period that might be anticipated for strong PE returns and a young portfolio age.

However, the last two years has seen a significant improvement as big deal activity has increased: the exit rate of the largest deals averaged 27% in 2014-15, well above the 20% for all deals; at the same time, the entry rate for the biggest deals also rose to 20% in 2015, after averaging only 4% in the 2009-13 period. As a result, the largest deals have a current portfolio age of just one year above the average.

A two-speed industry

Our analysis uncovered one factor that can explain the differential in the health of the industry — the speed with which individual PE firms (GPs) are able to generate and then realize value in their portfolio companies.

We grouped the investments in our analysis according to the investing GP and then determined the average age of each GP's portfolio of investments. From this, we were able to split the industry into two groups — GPs with a younger than average portfolio (i.e., below 4.5 years), which represented 40% of PE firms tracked in our study, and those with an older than average portfolio (or above 4.5 years), which represented 60% of firms. The results reveal that European PE is now a two-speed industry.

Figure 5 shows the key metrics of health for the two groups — average age of portfolio, exit rates and entry rates and returns. There are some stark differences. Given the basis of the grouping of GPs, it is no surprise that the average portfolio age is much lower for the "Young portfolio GPs", at three years, versus 6.7 years for the "Old portfolio GPs".

Figure 5. Key statistics, young portfolio GPs vs old portfolio GPs

	Young portfolio GPs	Old portfolio GPs
Average age of portfolio, years, at end December 2015	3.0	6.7
Exit rate (annual average):		
2005-08	15%	12%
2009-13	13%	9%
2014-15	24%	14%
Entry rate (annual average):		
2005-08	41%	45%
2009-13	11%	5%
2014-15	22%	6%
Pooled IRR (of all exits)*	27%	32%
2005-08 exits	53%	57%
2009-15 exits	19%	16%
Length of hold of exits*, years	4.9	4.3

*From EY Study Database

The difference in exit and entry rates explain the gap in current portfolio age between the two groups. The Young portfolio GPs have been far more active in realizing investments following the downturn, with broadly consistent exit rates through the 2005-08 growth and 2009-13 downturn period, plus a strong increase in the last two years. By contrast, the Old portfolio GPs have shown a lower rate of exit activity, relative to the Young portfolio GPs. While the Old portfolio GPs have increased exit activity in the last two years (up to 14% during 2014-15, versus 9% in the 2009-13 timeframe), the figure is well behind that of the Young portfolio GPs, and well below the 20% level that marks a healthy level of exit activity.

When it comes to new investments, the Old portfolio GPs were growing new investments at a faster rate than the Young portfolio GPs during 2005-08. However, this trend has since reversed, with new investment activity among Old portfolio GPs lagging far behind that of the other group (6% versus 22%, respectively, for 2014-15). As the Young portfolio GP group managed to maintain a steady exit pace both pre- and post-crisis, so they have been rewarded by investors with further capital to fuel new investments. This can be seen in the difference in entry rates between Young portfolio and Old portfolio GPs — a larger difference than the gap in exit rates. All the growth in new investment is falling to the Young portfolio GPs, which have been making a disproportionate share of new investments since the downturn. GPs with young portfolios accounted for 82% of the new investments made in 2015, or 102 of the 125 new investments.

LPs looking to the long term

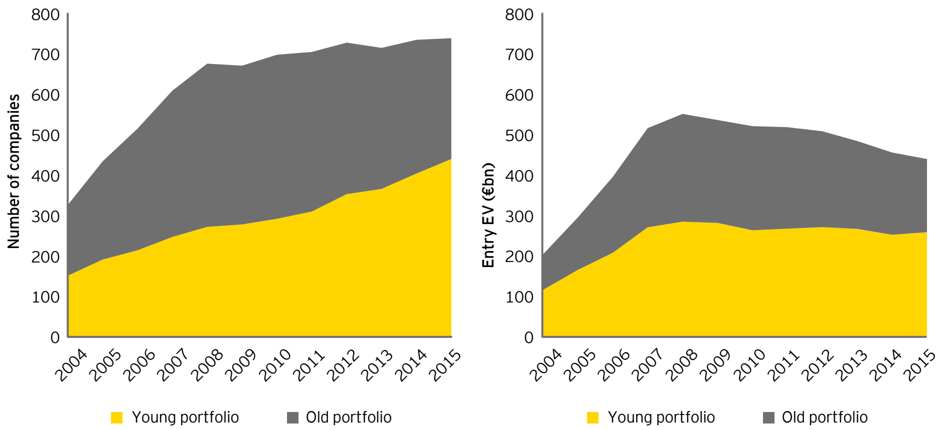
Our analysis of the two groups' record on value creation, based on our database of realized returns on exits for the whole 2005-2015 period, shows a slightly higher return for GPs with old portfolios, in part because they have a slightly shorter length of hold. Superficially, this is a surprising result – given that value creation record is a key determinant in GP fund raising.

This begs the question of why the Young portfolio GPs have driven all the growth in new investments, while Old portfolio GPs – with a slightly better track record of realized returns – have lagged. To determine why this might be, we split the returns data of both groups by time period. The results show that the Old portfolio GPs generated higher returns than the young group pre-crisis, between 2005 and 2008 (57% versus 53%, respectively). However, from 2009 onwards, the Young portfolio GPs overtake the other group to produce aggregated IRRs on exits of 19%, against 16% for the Old portfolio GPs. The downturn therefore appears to act as a watershed period for returns and activity levels, separating out those most able to generate returns through timely exits and those GPs that have struggled to do so.

In addition, our analysis shows that there is likely to be a more significant divergence over the coming years in activity and expected returns between the Young portfolio GPs and the Old portfolio GPs. Given the findings on gross IRR on exits by length of hold and source of gain (figure 4.), we are confident that the stark difference in average portfolio age between the two groups (three years versus 6.7 years) will lead to a material disparity in realized returns as the current portfolio is exited – for as we have shown, absolute returns and the effect of PE outperformance diminish with length of holding, and particularly for companies that are exited after seven or more years.

Measured over this long timeframe, this analysis suggests that investors are rewarding those GPs with consistent activity levels – as well as acceptable returns. By examining European PE as a whole split into these two groups, we can see clear evidence of a two-speed industry. The Young portfolio GPs have maintained a relatively steady portfolio entry EV from 2010 onwards, with the number of portfolio companies growing continuously throughout the period of our research. However, for GPs with old portfolios, after strong growth 2005-08, (in line with the Young portfolio GPs) the portfolio entry EV and portfolio numbers have been in steady decline.

Figure 6. PE portfolio by age of GP portfolio, number and entry EV



The current trends show that this two-speed industry will persist and the shift in industry share may accelerate. As we have already noted, the Young portfolio GPs accounted for over 80% of new investments in 2015, well ahead of their share of the current portfolio of 60%. By contrast, the Old portfolio GPs have 40% of the current portfolio, but accounted for less than 20% of new investments in 2015.

A shakeout in process

Taken together, our results point to a healthy, functioning European PE industry. Capital is flowing to those GPs with the agility to add value to their portfolio companies in a timely fashion, enabling them to achieve exits within the five-year holding period necessary to generate strong returns to investors. New capital clearly enables new investments. LPs are choosing to back GPs with young portfolios – those that are more successful in selling as well as buying businesses. By contrast, GPs that have taken longer to make operational and strategic improvements to their portfolio companies, and are therefore having to hold on to their investments for extended periods, are not active in the new investment space. The implication is that they have been unable to raise the capital needed to fund a healthy level of new deals.

This shows that there is a shake-out happening in European PE, as GPs with young portfolios surge ahead with new investment activity, leaving those GPs with old investments lingering in their portfolios far behind. This shake-out is slow, given the typical ten-year lifespan of a PE fund, but persistent, and set to continue as LPs look for the potential of a good, steady pace of exits before committing to new funds. This is a necessary development that will strengthen further the long-term health of the European PE industry.

Outlook

Our 2015 study demonstrates the importance of consistent activity in GP portfolios. By drilling down into the detail of European PE, analyzing GPs by their exit and investment pace plus their average portfolio age, we have shown that working effectively to add value to portfolio companies and exiting within a five-year time frame generates results that will attract further investment from LPs.

In so doing, we have also shown the strength at the heart of European PE. While the exit overhang remains an issue in the overall portfolio, there is a healthy core of GPs, with younger than average portfolios, which is clearly positioned to be the industry's future: these firms are making over 80% of new investments across the region.

The outlook for these firms is promising. Fundraising in 2016 has so far been strong and the signs are that it will remain steady as investors globally continue to seek outperformance in a volatile environment characterized by monetary policy interventions in many markets and persistently low interest rates. The simple fact is that PE is one of a small handful of asset classes that can provide good absolute and relative returns in current times. Indeed, our studies over the years have consistently demonstrated PE's ability to outperform. Evidence from this year's study shows, however, that LPs are being selective: they are backing firms offering the potential for strong cash returns through timely exits.

Nevertheless, 2016 looks set to be a more challenging year for exits and new investments. The numbers for both are likely to be lower than activity levels seen in 2015, with Europe facing some uncertainty over its economic prospects and, to some degree, over the eventual impact of Brexit. While conditions are likely to be far more favorable than in the aftermath of the crisis, a fall in business confidence may well compound some of the challenges faced by the group of GPs in our sample with old portfolios as realizations become harder to execute. The result will be a continuation of the shake-out of the industry we have observed in our study this year.

Yet for those with capital to deploy, uncertainty will likely bring opportunity as competition for deals reduces in intensity, particularly if corporate buyers become more circumspect around their M&A ambitions in Europe and IPO activity remains subdued compared with 2015 levels.

Overall, our study points to a strong core of the European PE industry in good shape, performing better than the headline industry numbers, and supported by an investor base that is effectively selecting the most agile players. There seems little doubt that it will evolve over the coming years as this change works through the industry. Our analysis demonstrates that European PE will emerge stronger, fitter and healthier as a result.

About the study

The 2015 study provides insights into the performance and methods of PE, on the basis of analysis of the largest European businesses that PE has owned and exited over the past 11 years.

To avoid performance bias, and to facilitate a focus on the largest European businesses owned by PE, exits were screened to capture only those that had an enterprise value (EV) at entry of more than €150m. This criterion also applies to our estimates of the current size of the PE portfolio, and the new investments into, and exits out of, this population. In total we have identified 898 exits of businesses that met our criteria over the study period from 2005 to 2015.

We analyzed business performance for the duration of PE ownership (i.e., from entry to exit) based on key performance measures, including IRR equity multiple (defined as equity realized over equity invested), change in EV, profit (defined throughout this report as earnings before interest, tax, depreciation and amortization or EBITDA) and valuation multiple (defined as EV over EBITDA). To measure aggregate economic impact, we used weighted averages.

In order to benchmark the performance of PE-backed businesses, we have compiled comparable financial data on over 6,000 public companies across European stock markets. This enables us to create country, industry sector and time-matched public company benchmarks for each PE investment. The data was then aggregated to compare the performance of PE-owned businesses with that of public companies over the period of PE ownership.

This independent study is built with public data across the whole population and detailed, confidential interviews with former PE owners of these businesses. Overall, we have performance data for 60% of the total population. Looking across key performance dimensions (e.g., deal size, sector, incidence of creditor exits), there is no discernible bias in the composition of the sample compared with the whole population.

The ability to incorporate data obtained directly from interviews with top PE investors is an important feature of the study. Another is the scope and depth of our research, with a data base of more than 500 European PE exits. Our study is recognized by many commentators as the authoritative work in this field.

EY contacts

EMEIA

Sachin Date
London

T: +44 20 7951 0435
E: sdate@uk.ey.com

Harry Nicholson
London

T: +44 20 7951 5707
E: hnicholson@uk.ey.com

Konstanze Nardi
London

T: +44 20 7806 9380
E: knardi@uk.ey.com

UK

John van Rossen
London

T: +44 20 7951 6026
E: jvanrossen@uk.ey.com

Belgium

Marc Guns
Brussels

T: +32 2 774 9419
E: marc.guns@be.ey.com

Central and Southeast Europe

Justin Fancher
Prague

T: +420 225 335 396
E: justin.fancher@cz.ey.com

France

Herve Jauffret
Paris

T: +33 1 55 61 07 96
E: herve.jauffret@fr.ey.com

Laurent Majubert
Paris

T: +33 1 55 61 06 29
E: laurent.majubert@fr.ey.com

Germany

Michael Kunz
Frankfurt

T: +49 6196 996 26253
E: michael.kunz@de.ey.com

India

Rajiv Memani
New Delhi

T: +91 124 671 4111
E: rajiv.memani@in.ey.com

Mayank Rastogi
Mumbai

T: +91 22 6192 0850
E: mayank.rastogi@in.ey.com

Italy

Umberto Nobile
Milan

T: +39 02 80 669 744
E: umberto.nobile@it.ey.com

Luxembourg

Olivier Coekelbergs
Munsbach

T: +352 42 124 8424
E: olivier.coekelbergs@lu.ey.com

Middle East

Matthew Benson
Dubai

T: +971 4 312 9 395
E: matthew.benson@ae.ey.com

Netherlands

Maurice van den Hoek
Amsterdam

T: +31 88 407 0434
E: maurice.van.den.hoek@nl.ey.com

Nordics

Michel Eriksson
Stockholm

T: +46 852 059 354
E: michel.eriksson@se.ey.com

Poland

Brendan O'Mahony
Warsaw

T: +48 22 557 8924
E: brendan.omahony@pl.ey.com

Russia

Leonid Saveliev
Moscow

T: +7 495 705 9702
E: leonid.saveliev@ru.ey.com

South Africa

Graham Stokoe
Johannesburg

T: +27 11 502 0370
E: graham.stokoe@za.ey.com

Spain

Juan Lopez
Madrid

T: +34 91 572 5195
E: juan.lopezdelalcazar@es.ey.com

Turkey

Demet Ozdemir
Istanbul

T: +90 212 368 5264
E: demet.ozdemir@tr.ey.com

Global

Jeff Bunder
T: +1 212 773 2889
E: jeffrey.bunder@ey.com

Michael Rogers
T: +1 212 773 6611
E: michael.rogers@ey.com

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