Survey of the Economic and Social Impact of Buyouts in the Netherlands

A look at the accelerated development of companies following private equity investment

November 2004
This paper considers the role played by private equity providers in buyout deals. It is based on a survey amongst Dutch buyout companies conducted on behalf of NVP and Ernst & Young by the Centre for Management Buy-out Research (CMBOR), University of Nottingham, United Kingdom in conjunction with Erasmus University Rotterdam.
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Foreword

We have also witnessed the steady rise in the number of management buyouts among Dutch companies over the past few years. Ernst & Young was therefore highly enthusiastic about the NVP's initiative to carry out a joint survey aimed at gaining a better insight into the social and economic impact of a management buyout on Dutch companies.

The positive results that the vast majority of the respondents achieved in the years following the buyout does not surprise us: previous research by Ernst & Young showed that the negative image that is sometimes associated with a buyout, is undeserved. This survey underlines our earlier conclusion: as a partner to management, the private equity investor is a stimulating factor not only when it comes to the financial development but also with respect to strategic choices such as investments in R&D and marketing, acquisition strategy and expansion of the product portfolio. More than 70% of the companies surveyed had monthly or even weekly discussions with their private equity investor regarding financial and strategic matters. These included formulating strategy, translating this strategy into daily practice, improving cash flow, cost efficiency and optimizing investments.

Private equity has developed into a real alternative to traditional forms of financing besides bank loans or stock exchange listing – a development that we very much welcome.

We would like to thank all the companies that participated in this survey for their support.

Robert Schipper
Chairman, Dutch Private Equity and Venture Capital Association (NVP)

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Partner, Ernst & Young Transaction Advisory Services

In this report, the term buyout is used to refer to all types of management buyout and buyin constructions. See also Appendix 3: Glossary.


Source: “Private equity: first practice, then theory” (April 2001)
Buyouts play an ever more prominent role in the private equity arena and so their economic and social repercussions are becoming increasingly significant though somewhat ill-defined. This survey therefore takes a closer look at the key reasons for the success of buyouts, focusing on the performance, corporate and business strategy and characteristics of companies that have attracted private equity.

The survey was conducted by means of a postal questionnaire, which was sent to 274 private equity backed buyouts occurring in the Netherlands from 1992 to 2002. In total there were 46 replies, equating to a response rate of 16.8%, which is higher than anticipated given that response rates have been falling and are now typically between 10 and 15% for postal questionnaires. The resulting sample of 46 is sufficient in size to be a good proxy for the whole market. Analysis of respondents has also shown these to be representative of the total population in terms of industry sector and size of company.

Post-buyout performance: accelerated development

The survey clearly shows that private equity financing enables companies to realize accelerated growth and improve their financial performance:

Growth in turnover:

- Annual average turnover growth rose from 5.5% in the year prior to the buyout to 22% in the year following the buyout. The average annual turnover growth in the three years post buyout was 13.4%.

Increased profitability:

- The average annual profit growth in the three years post buyout was 9.5%.

A finding that further underlines the fundamental contribution of private equity in the development of the buyout company, is the fact that:

- 56% of responding companies stated that they had developed faster as a result of the buyout.

A further 20% of the respondents said that they believed they owe their current existence to the buyout having taken place and 15% of respondents said they would have developed in the same way.

These principal outcomes reinforce the proposition that buyouts have a strong positive effect on companies involved and in consequence generate the highest returns.

Corporate and business strategy: growth and expansion

The survey supports the suggestion that, following a buyout, companies engage in strategic actions predominantly aimed at growing the business. These strategies are implemented across a broad spectrum:

- **Increased investment**: average expenditure (expressed as a percentage of sales) on training, capital equipments, marketing and research and development, increased unanimously in the period following the buyout. Most notably, expenditure on training rose by 46%, whilst investment in marketing rose by 31%.

- **Growth through acquisitions**: close to two thirds of the companies questioned had undertaken acquisitions, mergers or joint ventures since the change in ownership. Acquisitions were not only pursued locally but also on an international level, as 44% of those companies engaging in any form of acquisition, merger of joint venture activity said that they had undertaken acquisitions in, -or outside, the EU.

- **Product and market development**: in almost two thirds of cases, companies had increased their product range, whilst the majority of respondents also said that they had invested in new sites/locations as well as expanded their range of markets.

These actions result in:

- **Rise in employment levels**: over half of respondents (54%) reported that the total number of employees had increased since the buyout. The increases are particularly notable in the sales and marketing, and finance departments, reflecting the crucial role of these factors in growing the business.
and value creation respectively. In those companies that had seen a rise in the number of employees, the actual average increase was substantial at 46%. A further 23% said that the number of employees had remained the same.

■ **Value creation:** improved cash flow, heightened business efficiency and focused capital expenditure are considered by buyout companies as some of the key value drivers. The findings further provide strong evidence that value creation in buyouts is viewed by management as depending on a combination not only of enhanced control and efficiency, but also on the development of strategies for growth.

**Characteristics: commitment and involvement**

The involvement of both the private equity investor and the increased participation on the part of employees are also crucial elements underpinning the success of buyout companies.

The survey shows that buyout companies are characterised by:

■ **Support.** Buyout companies receive support from their private equity investor on both a financial level, in terms of funding and financial advice, and on a strategic level, helping management in the formulation, and above all execution, of the strategy. Over 70% of companies had contact with their private equity investor on a monthly or even weekly basis.

■ **Motivation.** Remuneration clearly plays a role in the drive to motivate employees. The number of employees receiving performance-related pay more than doubled to 18%. Furthermore, in the majority of cases total earnings for top and middle management increased between the year before the buyout and the last year.

■ **Involvement.** On average, management said that they had greatly increased attempts to make employees feel an integral part of the company. Employees in a buyout company are also more likely to be involved in setting targets and to be consulted on strategic matters following the change of ownership.
2 Background

The seller’s perspective
Two clear trends emerged with respect to the nature of those parties seeking to sell their stakes in companies and their motivation for doing so:

■ Foreign country and home country parent companies (28% and 24% respectively) look to buyouts as an exit strategy when the company involved is no longer considered to be a strategic fit or when the parent company is forced to reorganize and thereby divest a ‘crown jewel’

■ Private/family owners (39%) frequently use buyouts at the point of retirement when no clear or feasible succession is possible.

It is notable that only a very small minority of companies (4%) cited lack of profits or poor growth prospects as a reason for undertaking a buyout.

The private equity perspective
Buyouts are predominantly envisaged as a medium to long-term investment. Only 17% of the respondents declared an intended exit of less than four years.

The average equity share held by the private equity firms at the time the company is acquired, was 63%.

The type of company involved
From the results of the survey it is clear that buyouts occur across the spectrum of industry sectors. Interestingly, buyouts are not restricted to more mature sectors and companies. High technology sectors, covering biotechnology, computer hardware, software, services and semiconductors, electronics, telecommunications hardware, medical instruments and pharmaceutical activities accounted for almost a tenth of the sample.

Buyouts occur across a wide range of company sizes. The number of employees ranged from 1 to 10,000 employees, with a median value of 175. Relatively large companies (with 250+ employees) represented 40% of those companies surveyed.
3 Post-buyout performance: accelerated development

3.1 Strong financial performance

The immediate post-buyout period is characterised by a sharp rise in turnover suggesting that, with enhanced control and improved funding, management is capable of rapidly translating this into positive financial performance. This sharp rise also reflects the more prominent role given to marketing. From a starting point of 5.5% in the year before the buyout, the annual percentage change in turnover jumped to 22.0% in the following year. Although growth rate then characteristically fell, the average growth rate in the three years proceeding the buyout was 13.4%.

The average growth in profitability (in terms of Earnings Before Interest and Tax, EBIT) in the three years following the buyout was 9.5%. EBIT as a percentage of turnover, rose sharply in the year of the buyout to 9.7% compared to 8.6% in the year prior to the buyout. The average post-buyout EBIT margin was 9.3%.

Management was asked to judge their financial performance with that of their principal competitors. The result gives a clear impression of the sense of optimism and confidence in the company. Nearly 60% of respondents noted that turnover and EBIT had improved in comparison with competitors since the buyout, with the majority of these companies saying that the growth compared to principal competitors had been “much more”.

Fig. 3.1 Annual turnover growth rates pre-and post-buyout

The average growth in profitability (in terms of Earnings Before Interest and Tax, EBIT) in the three years following the buyout was 9.5%. EBIT as a

Fig. 3.2 EBIT growth compared to competitors since the buyout
3.2 Private equity as catalyst for accelerated growth

The overall impact of the buyout on the companies involved was seen as strongly positive. Of the responding companies, 56% stated that they had developed faster as a result of the buyout. A further 20% of the respondents said that they believed they owe their current existence to the buyout having taken place and 15% of respondents said they would have developed in the same way. Only 9% of those surveyed therefore said that they would have grown faster had the buyout not taken place.
4 Corporate and business strategy: growth and expansion

4.1.1 Investing in growth

The injection of capital into a business following a buyout may enable previously constrained businesses to undertake expenditure for longer-term strategic development in terms of training, capital equipment, marketing and research and development.

The survey shows that average expenditure (expressed as a percentage of sales) increased in the period following the buyout in all these four strategic areas. The largest increase (46%) occurred in respect of expenditure for training, whilst expenditure for marketing rose by 31%, to 5% of sales. This increase must also be seen in the context of the overall increase in turnover meaning that the absolute level of expenditure is greater still.

Fig. 4.1 Expenditure on activities (as a % of sales) before and after the buyout

4.1.2 Growth through acquisitions and/or joint ventures

The change of ownership and injection of funds enables companies to pursue acquisition-based as well as organic growth. Just over 60% of respondents had undertaken acquisitions, mergers or joint ventures since the buyout. The most common activity was local acquisition, undertaken by 56% of those buyouts engaging in any form of acquisition, merger or joint venture activity.

There was also evidence of internationalisation with over 40% of these buyouts making acquisitions abroad and 15% forming joint ventures with foreign companies.

4.1.3 Product and market development

The study reveals that buyout firms engaged in a wide range of strategic actions following the change in ownership. These strategies were predominantly aimed at growing the business and most frequently included:

- Increasing product range (65% of cases)
- Investing in new sites/locations (59%)
- Increased range of markets (52%)
- Expanding existing sites (46%)

There is also evidence to suggest that the change in ownership fuels greater focus resulting in a reassessment of activities and consequently a reduction of the product range or markets.

The emphasis on focus also comes through when looking at the trading performance, in terms of a company’s exporting activities and supplier relationships in the post-buyout period.

On average, the companies sampled experienced a modest increase in their exporting activities between the year before the buyout and the survey date. This suggests that consolidation of existing market positions is prioritised over international expansion reflecting to some extent the bias of private equity sponsors towards solid, proven business plans as opposed to the overly ambitious ones.

Table 4.1 M&A activity

<table>
<thead>
<tr>
<th>%</th>
<th>Acquisitions</th>
<th>Mergers</th>
<th>Joint Ventures</th>
</tr>
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<tr>
<td>Locally</td>
<td>56</td>
<td>6</td>
<td>12</td>
</tr>
<tr>
<td>Inside European Union</td>
<td>24</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>Outside European Union</td>
<td>21</td>
<td>0</td>
<td>9</td>
</tr>
</tbody>
</table>

(Note: Respondents could select more than one option therefore total can be greater than 100%)
A significant number of jobs are created in the local town/region of the company – in 25% of cases, management considered local employment to have increased. With 69% of respondents saying that there had been no adverse effect from the buyout on local employment, the survey shows that buyouts do not usually have a negative impact on this level.

The survey also found that the change in ownership resulting from buyouts can provide a means of enabling companies to develop a more effective supplier base. This may be effectuated by the a greater degree of stability of the company post-buyout and the space afforded to building personal relationships with suppliers. Over 40% reported that trading relationships with suppliers were better, or even much better, following the buyout. About 55% noted that their relationships had remained stable.

Post-buyout, companies also tend to either keep the number of suppliers stable (in 62% of cases) or to actually reduce them (in 27% of cases).

Partly as a result of the implementation of these growth measures, companies that have attracted the support of a private equity investor in a buyout, tend to increase the number of employees and to focus on a number of key value drivers, particularly with respect to financial matters.

4.2.1 Rise in employment
In view of the evidence that suggests buyout companies are engaged in the implementation of strategies for growth post-buyout, it is to be expected that the majority of responding companies (54%) reported that the total number of employees had increased since the buyout. Where an increase had taken place, the change was substantial with an average rise of 46%.

The survey found that there is an increase in all areas of management (apart from at the level of CEO/Managing Director and with technical management where numbers remained flat) following the buyout. In line with the increases seen in marketing expenditure and turnover, the largest net increase (33%) is in sales and marketing management. The net increase in the number of employees involved in finance (21%) is a reflection of the importance attributed to financial factors in creating value in the business.
4.2.2 Value creation

A number of factors within a number of areas contribute to value creation in the business strategy following the buyout. These factors can be grouped into financial, product/development, marketing, and general. The survey shows that financial factors such as improving cash flow, reducing costs and optimising capital expenditure, are considered to be some of the most important contributing factors to value creation following the buyout.

The findings further provide strong evidence that value creation in buyouts is viewed by management as depending on a combination not only of enhanced control and efficiency, but also on the development of strategies for growth. The ten most important value drivers are shown in descending order in Fig. 4.4.

![Fig. 4.4 Most important value drivers](image)
5 Characteristics: commitment and involvement

5.1 Support provided by private equity investor
Most private equity investors are actively involved with their investments and usually (over 70%) meet their portfolio companies on a monthly or even weekly basis.

The survey provides clear evidence that the role of the private equity partner extends beyond providing funding and monitoring performance. Private equity firms also provide the greatest degree of input by acting as a sounding board for management ideas and challenging the status quo.

5.2 Building a positive company culture
Companies that have undertaken a buyout more readily adopt an entrepreneurial culture made possible by the enhanced management freedom. This enables managers to apply a number of tools designed to motivate employees, thereby enhancing the greater awareness of ownership.

Remuneration: a motivating factor
The survey shows that the share of employees receiving performance-related remuneration of some form increases markedly following the buyout. The incidence of performance-related pay more than doubled from 8% in the year before the buyout to 18% in the last year of the survey.

Over half of companies reported that total earnings (including fixed, variable earnings and equity package) had increased for management between the year prior to buyout and the last year.

Management style: greater employee involvement
Within this more entrepreneurial environment, there appears to be a recognition for the crucial role played by employees in the achievement of business success. Management of employees is thereby characterized by attempts to close the gap between management and employees by involving employees more in company affairs. Enhanced communication, and greater employee input in the budget process are crucial elements of this.

Respondents were asked to rank a number of factors relating to how the management style had altered since the buyout, by scoring on a scale between 1 (decreased greatly) to 5 (increased greatly). The most
important factors in management approach are illustrated below. It is significant that none of the factors identified achieved a lower than average score.

**Fig. 5.3 Changes in management style**

- Attempts to make employees feel an integral part of the company
- Employee involvement in setting targets
- Frequency of communications
- Consultation on strategic matters
- Regular staff meetings/team briefings

Decreased greatly | Increased greatly
Appendix 1: Survey methodology

Aim
In the absence of a clear understanding of the main reasons for the success of buyouts, this survey was designed to examine the following dimensions of the economic and social impact of management buyouts:
- Background of buyout deals including reason for sale and expected timescale to exit
- Performance of the buyout
- Corporate and Business strategy
- Personnel and management issues
- Relationship with private equity investor.

Sample
The survey was carried out among buyouts that had taken place in the Netherlands between 1992 – 2002. This timeframe was chosen in order to obtain a sufficiently long period post-buyout for changes in performance to be identified. The sample for the survey was derived from the Centre for Management Buy-out Research (CMBOR) database, which contains details of over 20,000 management buyouts carried out in Europe.

The CMBOR database contains a total number of 651 buyouts completed in the Netherlands between 1992 to 2002, of which almost half (298) had private equity backing. Contact details were available for 274 of these private equity backed buy-outs and a questionnaire was sent to each one.

Questionnaire
The questionnaire was based on one used in an earlier pan-European survey carried out by CMBOR on behalf of the European Venture Capital Association (EVCA) in 2000. The NVP survey was carried out between May and August 2004.

Respondents
Results from the NVP survey were combined with replies received from Dutch buyout companies to the EVCA survey. In total there were 46 replies, which represent 15.4% of the whole population (298) or 16.8% of those contacted (274). Although the response rate to questionnaire surveys has been falling in recent years this return of 16.8% was higher than normal, for instance the original pan-European study on which this survey was based achieved an overall return rate of 12.7%.

The error resulting from using a sample of 46 to represent the whole population (298) has been calculated using the Standard Error of Percentages (STEP). This confirms that by using a sample of 46 we can be 95% confident that the results are within 15% of the true outcome. The resulting sample of 46 is therefore sufficient in size to be a good proxy for the whole population.

Responses by year are shown in Table A1.1, indicating a fairly even distribution between 1994 and 2002, which is similar to the distribution pattern of the whole population of buy-outs during this period.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
</tr>
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<tbody>
<tr>
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</tr>
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<td>1993</td>
<td>0</td>
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<td>1994</td>
<td>6</td>
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<tr>
<td>2001</td>
<td>4</td>
</tr>
<tr>
<td>2002</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>46</td>
</tr>
</tbody>
</table>

Responses to the survey have been analysed by business sector in order to assess how representative the sample is. This has then been compared to the industrial sector distribution of the overall population using CMBOR’s database, which shows good correlation as illustrated in Figure A1.2.
Responses have also been analysed in terms of the size of the business, measured by the number of employees. This has also been compared to the overall population using CMBOR’s database, again showing the sample to be representative as illustrated in Figure A1.3.

Fig. A1.2 Industry sectors from survey compared to CMBOR database

Fig. A1.3 Comparison of employee numbers in sample to CMBOR database
Appendix 2: Profiles

De Nederlandse Vereniging van Participatiemaatschappijen (NVP)

The Dutch Private Equity & Venture Capital Association acts in the interests of private equity companies in the Netherlands. The aims of the NVP are:

■ In cooperation with the government, work on an adequate regulatory framework for the private equity sector and its clients;
■ Inform entrepreneurs and businesses about the financing possibilities of private equity;
■ Inform investors about the characteristics of private equity as an asset class;
■ Raise awareness and improve the image of private equity to achieve aforementioned goals;
■ Contribute to further raising the level of professionalism of the private equity sector.

The NVP has more than 50 members and 50 associated members. Members are private equity companies whose principal activity is to provide private equity to private companies. The investment activities of the NVP members extends from providing seed and start-up financing, to providing expansion financing, to financing buyouts and other late-stage investments. A number of members are part of a bank, insurance company or pension fund (captives), whilst other are independent. Regional development offices have also joined the NVP. Members of the NVP represent 95% of the number of private equity investments and about 85% of the total invested capital in the Netherlands.

More information about the activities of the NVP and its members can be found on our website www.nvp.nl.

Ernst & Young Transaction Advisory Services B.V.

Ernst & Young Transaction Advisory Services B.V. (TAS) has bundled all its experience and expertise in the area of corporate finance. Ernst & Young TAS has all the necessary in-house expertise whether it concerns acquisition, divestment or merger processes, or valuation, financing, or restructuring issues. Furthermore, our advisors form part of the international network of Ernst & Young. Our group is divided into six specialist areas:

1 Transaction Support
2 Mergers & Acquisitions Advisory
3 Valuation
4 Capital Markets
5 Project Finance
6 Restructuring

More information about Ernst & Young and the services it provides can be found on our website www.ey.nl.
Appendix 3: Glossary

**Bridge financing**  Investment to finance growth prior to a public listing.

**Buyout financing**  Financing of takeovers whereby a portion of the shares are acquired by existing management (management buyout, MBO) or by new management (management buyin, MBI).

**Captive (fund)**  Subsidiary of a bank or insurance company or sometimes institutional investor. One of the characteristics of a captive fund is that it can source funds from the parent company when an attractive investment opportunity arises. As a result, the total available capital of such funds are not always easy to gauge.

**Divestments**  Sale of (part of) a stake in a company to other shareholders or third parties, or (re-)payment of loans, interest and dividend, or write-off of an investment as a result of the decrease in value or bankruptcy.

**Early phase financing**  Collective term for seed and start-up capital and other financing for the initial growth phases of companies.

**EVCA**  European Private Equity & Venture Capital Association.

**Exit**  Type of divestment, namely the sale of a stake in a company.

**Expansion financing**  Investment to finance the further commercialisation of production and marketing for companies that have completed product development but that are not yet profitable. Also used to finance growth in mature companies.

**Financing phase**  The phase in which a company is in when financing is extended. The following financing phases are used: seed, start, expansion, buyout and other (turnaround and refinancing).

**Fund-in-funds**  Funds that participate in other private equity funds and therefore invest indirectly.

**Investor buyout (IBO)**  Sale of a company or division to a private equity company.

**Late phase financing**  Collective term for buyout financing and other financing for mature companies.

**Management buyout (MBO)**  Sale of a company or division to existing management. Large buyouts usually involve a portion of the shares being bought by a private equity company in cooperation with management.

**Market capitalisation**  The total value of capital invested in shares.

**Private equity**  Investments in private companies. Private equity includes both investments in young, high growth (technology) companies – often referred to as venture capital – and investments in mature companies.

**Secondary buyout**  Buyout where the stake is acquired by another private equity company.

**Seed financing/-capital**  Financing for research and development of the initial concept before the start-up phase has been reached.

**Start-up financing/-capital**  Financing for product development and the initial marketing activities of a young company.

**Turnaround financing**  Investment in a company that is loss-making and whose continuity is not safeguarded without external capital. A viable company can again be achieved through the investment and reorganisation.

**Venture capital**  Capital that is available in the short- or long term for relatively high risk investments (risk capital). Primarily for investments in young, high growth (technology) companies.
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