INDUSTRY STUDY:

Venture capital and private equity investors' impact on corporate growth 2010–2017

KPMG

Pääomasijoittajat

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Key observations in the industry study:

- Businesses owned by venture capital and private equity (PE) investors are among the fastest growing companies in Finland
- Turnover of PE-backed businesses has grown on average six times faster than at peer companies
- The number of personnel in companies owned by PE investors has increased on average 15 times faster than at peer companies
- Developing business operations and enabling growth require investments – Buyout companies have been able to grow and improve their profitability simultaneously

Introduction

The purpose of this report is to provide an overview of the impact of venture capital and private equity investment on Finnish business activities. The material in the report consists of companies that received an initial investment from a Finnish private equity investor in 2010–2017. The analysis was implemented by KPMG Oy Ab in cooperation with the Finnish Venture Capital Association.

Private equity investment means corporate financing outside the stock exchange, which is often done in the form of equity financing and is typically channelled to the marketplace through PE investment funds. Private equity investors manage funds whose largest investors include, e.g., employment pension companies and other institutional investors. Investments are, in principle, made for the medium or long term and characterised by active ownership. Active ownership means that the main shareholder engages in close cooperation with the company's management to develop its business operations.

In this report private equity investment In this report private equity investment has been divided into two categories: Venture Capital (hereinafter "VC") and Buyout (hereinafter "BO"). VC investments are targeted at early-stage companies that need investments and experts to develop and grow the company. In this context, a VC company refers to a company that has received a VC investment. BO investments are often directed at medium-sized companies and are, in terms of their profile, less risky than investments made in VC companies.

Private equity investment provides many benefits. One of them is strengthening the financial standing of the company. PE investment enhances the company's balance sheet, which enables the company to make new investments or find debt financing for growth.

In addition to capital, PE investors provide companies with strategic expertise, develop the reporting and management systems, create modern incentive and commitment models, and make their own contact networks available to the company for rapid development of business operations. PE investors enable

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companies to access new markets through their extensive networks, both at national and international levels.

This report focuses on the impact of private equity investors on three different subject areas in corporate operations: growth of companies, increase in personnel, and profitability.

e.g. for companies that obtained an investment in 2010, the review extends until 2013. During the 2010-2014 period, there were 125 BO companies and 160 VC companies that received their initial investment from private equity companies.

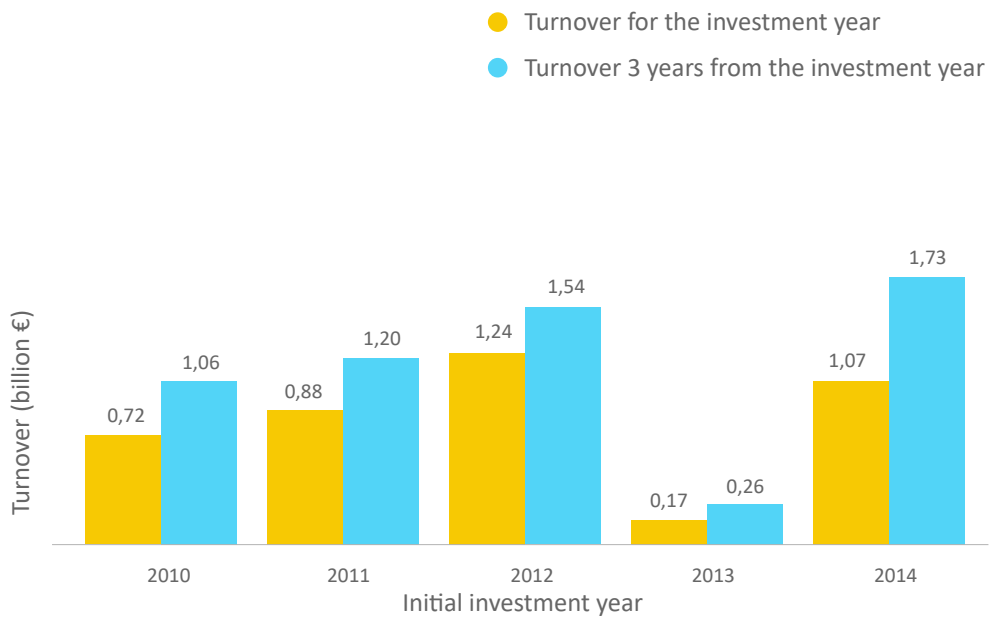
Growth: Businesses owned by venture capital and private equity investors are among the fastest growing companies in Finland

The goal of private equity investors is to generate rapid growth for their target companies by means of development of business operations and through both organic growth and acquisitions. Some of the growth in turnover at such companies comes with acquisitions, but much of the change takes place organically as the company grows.

Results of the study:

We studied the development of companies that received their initial investment between 2010 and 2014 over a three-year period;

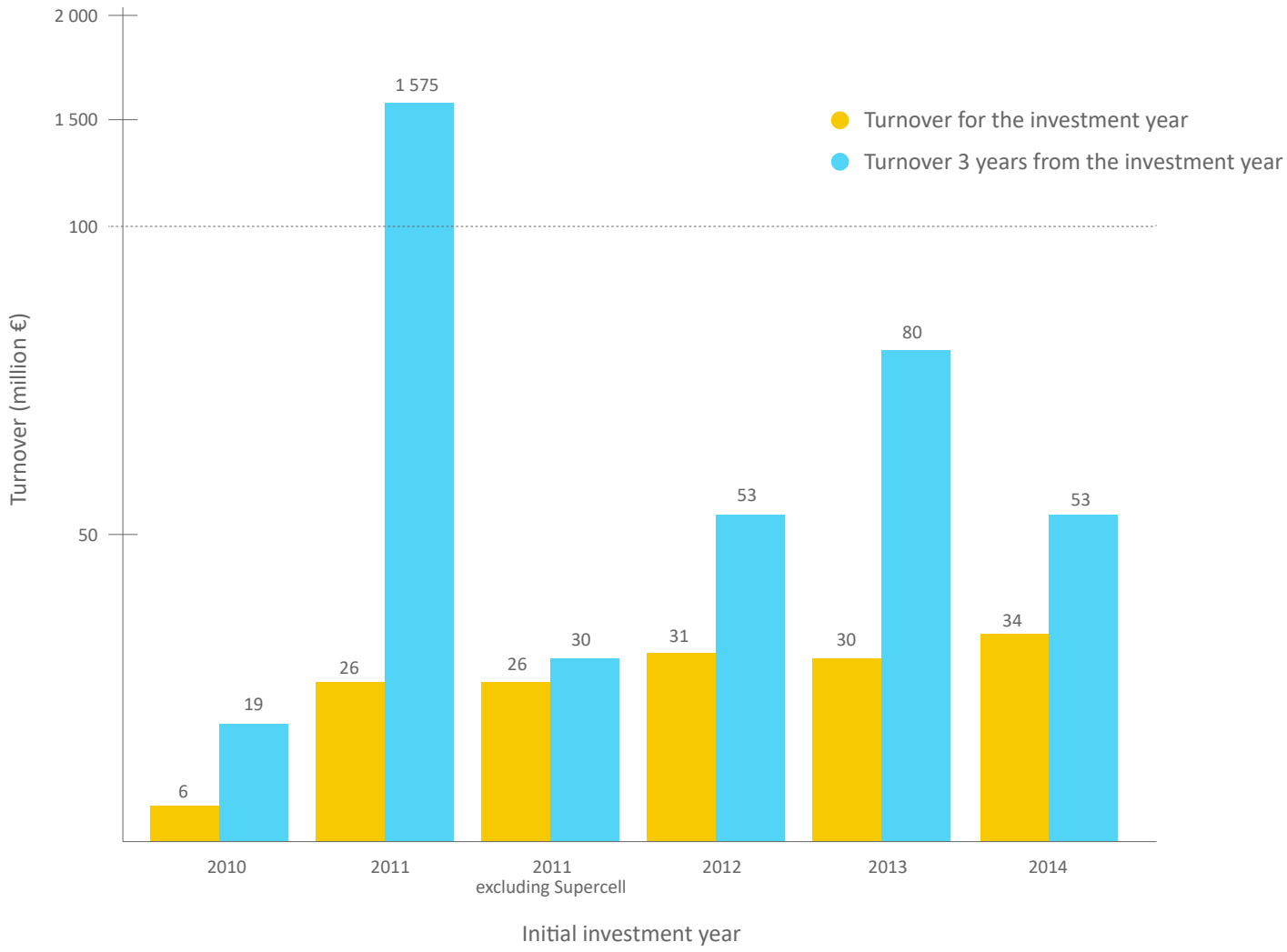
The combined turnover of BO companies, shown in graph 1, was €4.1 billion in investment years 2010–2014, whereas the combined turnover three years after the investment was €5.8 billion. The handprint of BO investors is evident in the growth of €1.7 billion where investments were made in the development of business operations as well as in organic growth and acquisitions. This growth of €1.7 billion can be compared to the annual turnover of the 30th largest company in Finland.



Graph 1. Buyout companies' turnover for the investment year and 3 years from the investment

For VC companies, growth has been significant and most of it was generated organically. Graph 2 shows that the combined turnover of VC companies in investment years 2010–2014 was €126 million, while the combined turnover three years after the investment was €1.8 billion. This growth was mostly due to Supercell which had a turnover of approximately €150 thousand in investment year 2011, whereas that figure in 2014 was about €1.5 billion. Thus the combined turnover of VC companies three years after the investment without Supercell was approximately €235 million.

Supercell is a good example of the importance of private equity investors as enablers of corporate growth. Where competition intensifies and companies see an increasing need for growth, PE investors act as strategic and financial partners. Although VC investors aim at the highest profits possible by carefully selecting which startups to invest in, an estimated one-half of companies that receive a VC investment fail to execute their business plan and close down operation within a few years.



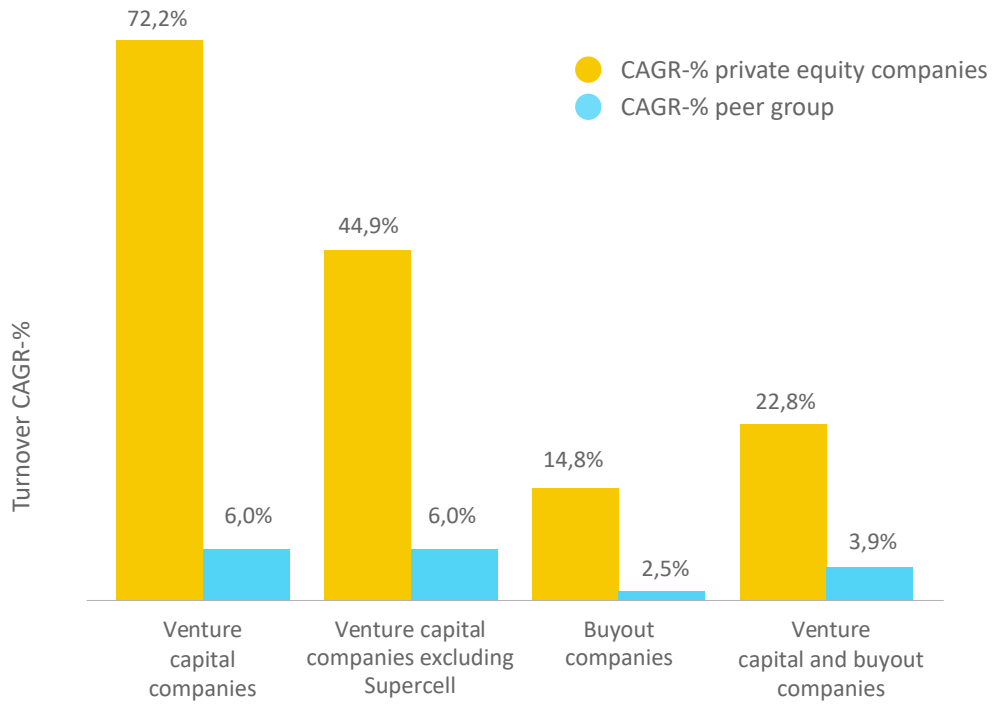
Graph 2. Venture capital companies' turnover for the investment year and 3 years from the investment

As an example, in addition to the 266 VC companies (in 2010–2017) in our study, financial figures for 104 VC companies were unavailable. Our estimate is that, at most, about 10 percent of these 104 companies were part of a successful acquisition. Hence one can say that since private equity investors seek high profits with their VC investments and look for "the next Supercell", the investment activity involves significant risks. PE investors try to manage their own risks by dividing their investments among several companies, aiming to ensure a positive yield for the fund as a whole.

In our study, we wanted to find a comparable group that could be compared with target companies that received an investment. Therefore, a peer group was created for every combination of investment type and initial investment year, and the criteria for these are explained in detail in the Methodology paragraph.

The peer group was compared with target companies by using the Compound Annual Growth Rate (CAGR) figure. CAGR refers to an annual growth rate, so in this section we studied the annual growth rate of turnover and the next section focuses on the annual growth rate of personnel. Said CAGR figures are presented in graph 3. The average three-year CAGR of BO companies in comparison with the peer group was clearly higher, with the average CAGR at 14.8% for BO companies and at 2.5% for the peer group.

The trend in VC companies in relation to the peer group was high, both with and without Supercell. With a sampling of all VC companies, the three-year CAGR was 72.2% and excluding Supercell the corresponding CAGR stood at 44.9%. VC companies did much better than the peer group, with CAGR of 6% for the peer group. CAGR could not be calculated for VC companies that did not have any sales in the investment year. In addition to this, one should note that the CAGR figures of VC and BO companies are not comparable with one another due to the difference in the companies' size.



Graph 3. Venture capital and buyout companies' 3-year average turnover CAGR-% compared to peer group

The combined average three-year CAGR of BO companies and VC companies was 22.8%, whereas the peer group's corresponding figure was 3.9%. Thus we can state that the annual growth rate of turnover at private equity backed companies is six times higher than at other companies in the industry.

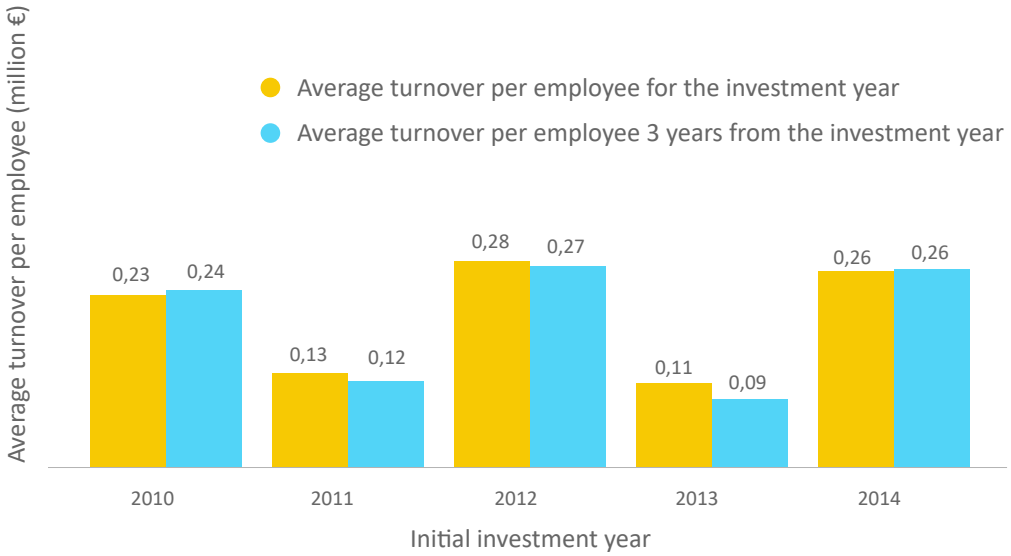
Results of the study:

In line with previous studies, we have observed that private equity investments increase the number of personnel at the target companies in our study. At VC companies, the combined number of employees at businesses that received their initial investments in 2010–2014 was 1400, whereas that figure had increased by more than one thousand, to 2500 employees, three years after the investment year. Our estimate is that almost all of that increase in personnel is organic growth, i.e., PE investors have created new jobs with regard to VC investments. Acquisitions have a greater impact on the growth of personnel at BO companies. According to our study, the number of personnel at BO target companies receiving initial investments in 2010–2014 increased from 20 thousand to about 30 thousand employees three years after the investment.

Personnel: The number of personnel in companies owned by PE investors has increased on average 15 times faster than at peer companies

Companies that are funded by private equity investors can hire more employees in order to enable growth. On the other hand, rapid growth also requires hiring new employees to enable growth in the long term. This is seen as a positive factor for both such companies and the Finnish economy. Some of the increase in personnel comes with acquisitions, but much of the change takes place organically as the company grows.

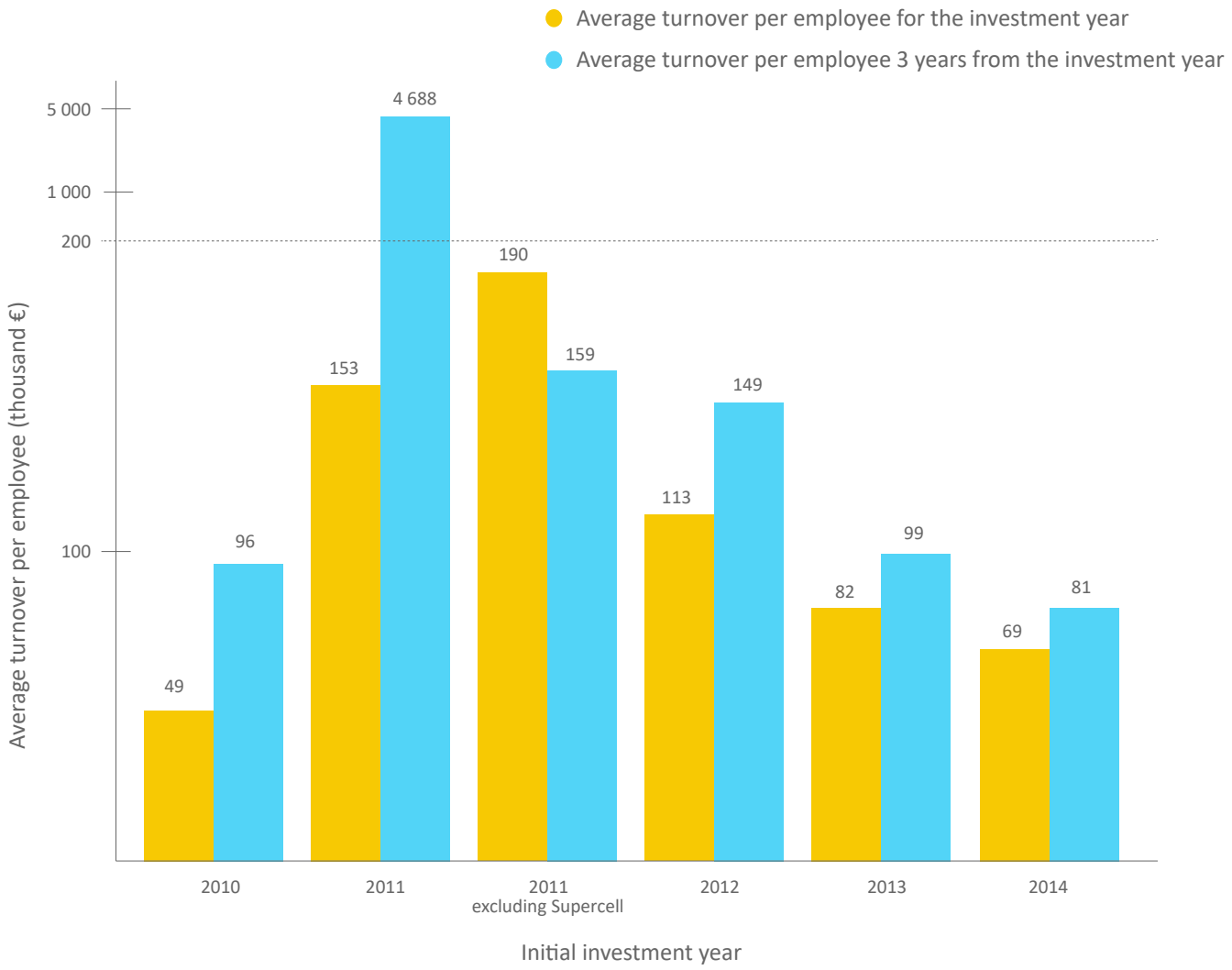
Another indicator that describes the development of a company in relation to staff is the company's average turnover per employee. This relation is also reviewed over a three-year period from the year of the initial investment. For BO companies, we can look at graph 4 which shows that the average turnover per employee three years from the investment remains largely unchanged from the level in the investment year. This suggests that the number of personnel increases in line with the growth at the companies.



Graph 4. Buyout companies' average turnover per employee – for the investment year and 3 years from the investment

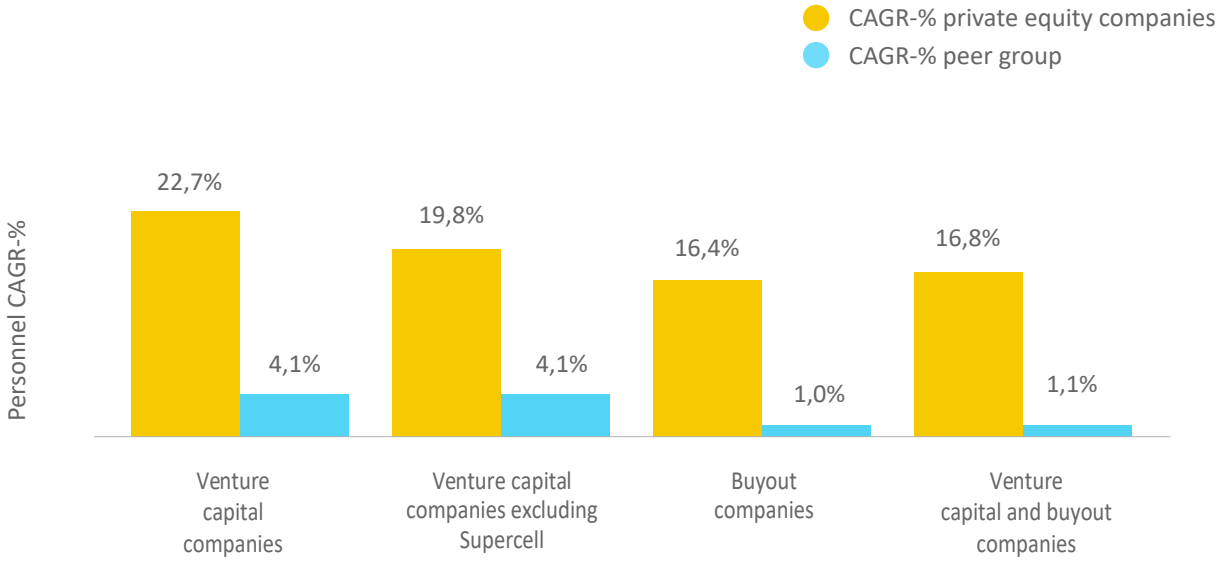
Graph 5 shows us that at VC companies average turnover per employee grows considerably compared with the previous period, which means that the hiring of employees has not been in proportion to the companies' growth of turnover.

Said indicator does not tell the whole truth: Many VC investments are based on a scalable business model at the VC company, so the same resources can produce service for a growing number of customers. VC companies often have a very low turnover at the time of investment, so average turnover per employee easily grows more in comparison with larger BO companies.



Graph 5. Venture capital companies' average turnover per employee – for the investment year and 3 years from the investment

Average CAGR in personnel growth at BO companies is much higher than annual personnel growth rate in the peer group. At BO companies, annual personnel growth was 16.4% whereas the peer group's annual growth rate was only 1%. VC companies, have a much higher annual growth rate, CAGR of 22.7%, while the peer group's corresponding figure was 4.1%. When personnel growth at Supercell is excluded, the annual growth rate of staff at VC companies was 19.8%. The results are shown in graph 6. It is not very surprising that VC companies have higher growth in personnel than BO companies, given that the increase in employees should naturally be high at relatively small, rapidly growing companies compared with what one would assume in large, mature businesses.



Graph 6. Venture capital and buyout companies' 3-year average personnel CAGR-% compared to peer group

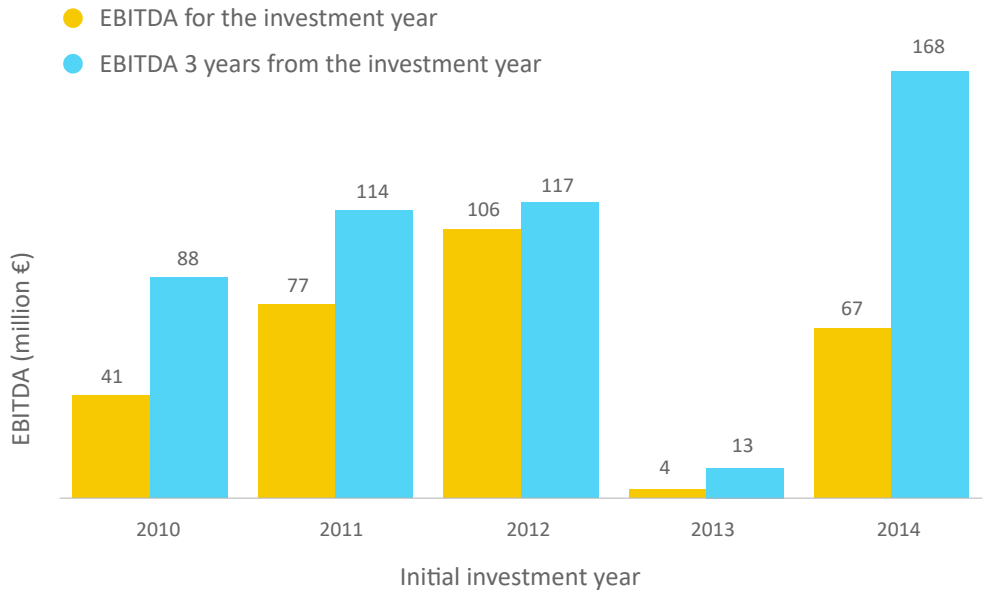
The combined average three-year CAGR of BO companies and VC companies was 16.8%, whereas the peer group's corresponding figure was 1.1%. Thus the number of personnel in companies owned by PE investors has increased on average 15 times faster than at peer companies.

Results of the study:

In our study, we have used EBITDA as the indicator of a company's profitability. Results concerning BO companies are shown in graph 7. The combined EBITDA of companies that received their initial investment in 2010–2014 is less than €300 million in the investment year, while the figure three years after the investment stands at almost €500 million.

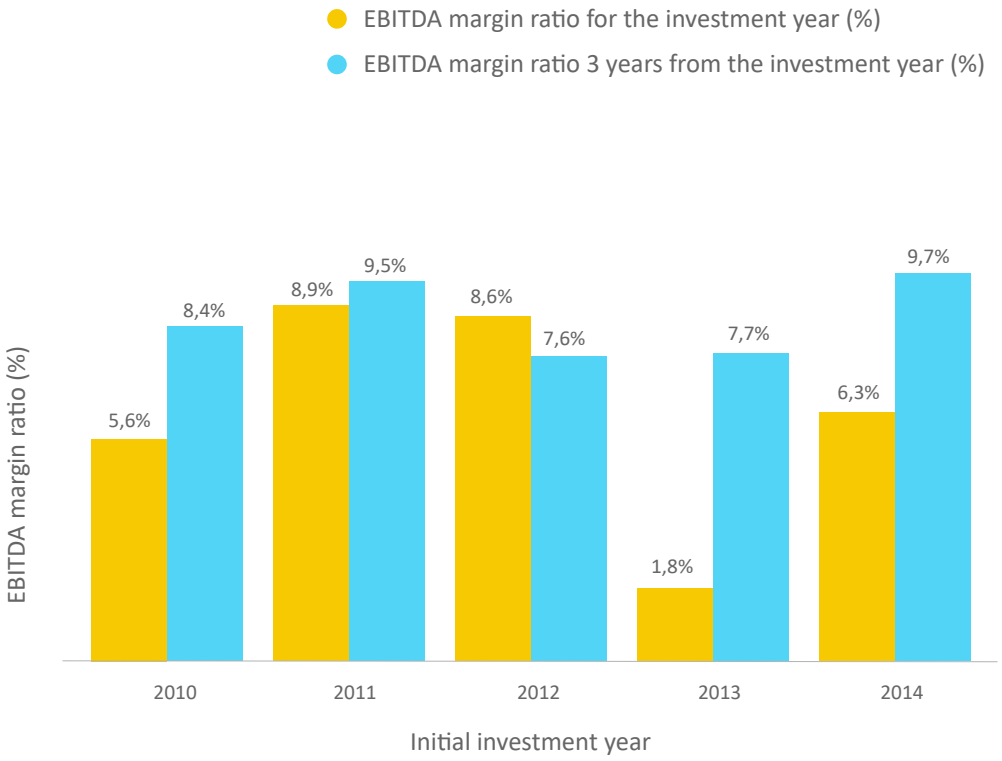
Profitability: Developing business operations and enabling growth require investments – Buyout companies have been able to grow and improve their profitability simultaneously

A company can have many motives for seeking external capital, but the main reasons are often the same: the company either seeks growth or is in need of revitalisation or a similar change. Growing a company, revitalising it and developing its business operations are often expensive; although BO companies have sought rapid growth through investments, they have still managed to improve their profitability.



Graph 7. Buyout companies' EBITDA for the investment year and 3 years from the investment

The absolute growth in the EBITDA is tremendous, but it should be compared to the companies' growth in turnover. The EBITDA margin ratio, calculated as the EBITDA in relation to turnover, is presented in graph 8. The graph tells us that although the companies had an explosive growth in turnover (shown in graph 1), their profitability grew, on average, even faster than the turnover. Hence it can be stated that BO companies have managed to grow profitably.



Graph 8. Buyout companies' EBITDA margin ratio for the investment year and 3 years from the investment

The combined EBITDA at VC companies in the investment year was approximately €26 million negative. Three years after the investment the EBITDA stood at €456 million, of which Supercell accounted for almost €515 million. Graph 9 shows VC companies both including and excluding Supercell, where the combined EBITDA without Supercell is €59 million in the negative three years after the investment.

Graph 9. Venture capital companies' EBITDA for the investment year and 3 years from the investment

Graph 10 illustrates VC companies' EBITDA margin ratio which is negative, as expected. However, the companies' turnover has increased despite their negative EBITDA. VC investment targets are startups that often are losing money and need funding to continue operation and seek growth. Small companies often look for growth by hiring more employees, using marketing efforts, developing production, etc. These factors are costs that have a direct impact on profitability, as we can see in graph 9. When a company grows, one can expect profitability to follow such growth. This can be noted by viewing the successful, profitable growth of BO companies and Supercell.

Graph 10. Venture capital companies' EBITDA margin ratio for the investment year and 3 years from the investment

Methodology, framework, and constraints of the study

The premise for this study is annual data provided by Finnish venture capital and private equity investors of their investments in 2010–2017. The sample in the 2010–2017 period comprised 604 target companies, 489 of which could be included in the study based on the availability of their financial figures. Of these 489 companies, 223 were in the BO category and 266 in the VC category.

In our study, we wanted to find a comparable group that could be compared with target companies that received an investment. Thus a peer group was created for every combination of investment type and initial investment year, in accordance with the following criteria:

— The peer database includes 87,000 businesses with a turnover of more than €100 thousand in 2014.

— For every combination of investment type and initial investment year, all companies are selected from the database in the same industries with turnover between the turnover of the smallest and largest company receiving a PE investment.

— Deleted from the peers are the 0.5% fastest growing companies and 0.5% of the most decreased companies, due to potentially incomparable financial details.

— A weighted average is calculated of the turnover growth rates, by industry, in the same proportion as the target companies' turnover is divided among the industries.

Summary of the report

The findings indicate that private equity investors have a positive impact on their portfolio companies. The turnover and number of personnel at companies owned by PE investors have grown much more in comparison with the peer group. Further, the profitability of BO companies has increased significantly. VC companies require significant investments in growth, so profitability is not manifested in a three-year period but can be expected to improve later on.

Private equity investors contribute managed risk-taking and competence in growing business operations to their companies. This cooperation results in startup companies that succeed in the global marketplace as well as strong domestic and international small and medium-sized companies. This enhances growth and employment in Finland.

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