Reading the *Market*

LGV-2007 in Review

LGV

Introduction

It is approaching 20 years since LGV established itself in the buyout business. For those of us who had worked in the industry since its beginning in the early 1980's, this was an exciting time to join a new team as the buyout industry emerged as a serious phenomenon in the UK. There was the thrill of unlocking businesses such as (in LGV's case) Anglian Windows and McBride, and freeing management teams from the constraints of corporate ownership thereby encouraging entrepreneurial talent. Management dug deep into their life savings to invest alongside firms such as LGV and the public markets provided the natural exit route for the next stage of a company's development. When we paid 8x EBIT (not EBITDA!) for a business we thought this expensive – those were the days!

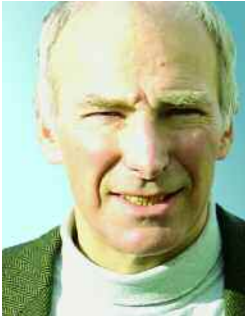
On reading the contribution to this latest LGV update from the Evening Standard's Business Editor and well respected commentator Anthony Hilton, we see how dramatically things have moved on. The proliferation of secondary and tertiary buyouts, double digit EBITDA (not EBIT!) multiples, covenant lite/second lien debt structures and private equity bids for household-name FTSE 100 companies have changed the landscape. Seeing industry colleagues in the spotlight last year before the Parliamentary Treasury Select Committee was a reminder of how far private equity has come and with it, the responsibilities it has to assume.

What hasn't changed are two fundamentals. First, the importance of good management. At LGV we have been fortunate to work with top quality managers. This has always been the key to our success, most recently with Tragus, Kingfield Heath and South Lakeland Parks. These management teams have grown and, at the same time, improved the underlying quality of their businesses to the benefit of the wider stakeholder community. This in turn has created value for our Limited Partners, who include a significant number of pension funds. The second fundamental is to buy well. At LGV our strategy during 2007 has been to sell into the current market and adopt a cautious approach to buying. Indeed in the last eighteen months, close to £1/2 billion has been returned to our Limited Partners.

With the benefit of working through a number of cycles since the early 1980's, it is with strong personal conviction that I say we have been right to pursue this approach and exercise discipline during this period. At the time of writing it appears that market conditions are changing and I expect there to be an increasing number of buying opportunities this year.

Private equity has proved itself to be a highly successful and resilient asset class that will continue to offer tremendous investment potential. We look forward to working with you in the coming months as the industry enters another period of change.

Adrian R B Johnson, Chief Executive, LGV



Anthony Hilton

The Business Editor of the London Evening Standard sets out his observations on the UK private equity market

The world's most successful investor Warren Buffett is famous for saying that only when the tide goes out do you see who has been swimming without trunks. Legions of other Americans down the years have used the phrase that when the going gets tough, the tough get going. Underlying both and others in a similar vein is the insight that uncomfortable though bad times may be, they do separate those with skill from those with luck, the talented from the merely opportunistic.

Economic prospects this year are already quite different from what we had grown used to in the long bull market. Whatever hopes bankers may have nursed that the credit problems which began last year would quickly be resolved have been dashed. Now the prediction is for a long and possibly brutal squeeze as the financial system de-leverages and glasses long thought of as half full are now universally perceived as half empty.

Confidence is all and confidence has evaporated. Those huge multi-billion private equity deals which were so easy to finance last year, and those refinancings at seven or more times EBITDA which became almost commonplace, now seem like relics from a different age. It is like stumbling across a clothes fashion from the previous decade - we wonder how we could ever have thought these things would last.

But just because the private equity market is tough does not make it impossible. Some things at the top end probably are - we are not going to see another deal like the purchase of Alliance Boots or the tilt at Sainsbury for some time. The moment has passed for public to private highly levered mega-deals and for those smaller transactions which wore the private equity cloak but were disguised bets on property values. But this is not the end of the story. What it does in fact is highlight how there have always been two strands to private equity value creation - the value which comes from financial engineering, leverage and multiple enhancement on the one hand, the profit which comes from operational improvement, focus, control and running the business better on the other.

Generally speaking the bigger and more

public the deal the more important financial engineering was in the mix. As competition for deals increased, so too did the amount of debt and the heroic assumptions of future growth in the business plans. These are the deals - those of the last 12 months where the prospects for embarrass-ment loom large.

Though such excess was less publicly apparent in the mid market and below, it was nevertheless there. The cheapness and the availability of debt caused prices to rise and ratcheted up the amount of leverage enough to make it a sellers' rather than a buyers' market. These are dangerous waters for portfolio managers because when the competitive juices get flowing and euphoria abounds it becomes seductively easy to overpay. This of course is where the management of the fund comes into its own - first in seeing the market for what it is and taking profits then having the self discipline not to overpay even if it means not closing deals.

In many ways therefore the market in 2006 and the first part of 2007 should be seen as an aberration - a time when pricing was dominated by the availability of finance rather than the prospect of operational improvements. Whether these take the form of finding and injecting management who can run the business better, focusing on the parts of the business with real growth potential, or buying competitors to build market position, it is all about having a clear strategic view of what the business is there to achieve and going for it.

However it would be naive to believe this business is going to sail through the credit storms unaffected. There is a real prospect of a sharp slowdown in economic growth this year to the extent that the woes of the financial sector spread to the wider economy. The banks already show marked reluctance to commit more than £100 million to a deal - those requiring more may need to be syndicated which is time consuming and frustrating.

It follows that private equity transactions this year will have more equity and less debt - but it also follows that there may be less competition for them, particularly from houses which may have over-egged earlier transactions and now have to devote resources and equity to keeping these afloat. Houses whose skills are financial rather than operational will also be less aggressive. Exits will also be harder to achieve, holding periods

will be longer and this will depress internal rates of return - or looking at it another way, it will blow off the froth and lead to less hype and more realistic expectations of what the industry can generate long term. Another advantage: the less frenzied economic conditions should also lower the industry's profile and bring respite from the public and political scrutiny of last year, the more so if there is widespread compliance with the guidelines for greater disclosure recommended in the industry review conducted by Sir David Walker. These are markets which reward the soundly based firms - those with a reputation for long term steady performance and good industry contacts.

The great plus for the private equity industry in any slow down is that the price of target companies drop. How far they fall depends on many things apart from finance, among them the severity of the economic slow down and the degree of pressure under which sellers find themselves, But fall they certainly will. And this should be welcomed by the industry because history has proved in each of the cycles of the last 30 years that buying cheaply and shrewdly in the trough is the real key to private equity success when the cycle turns. It is also the case that an economic slowdown will not cut the number of opportunities - if anything it will concentrate the mind of the management of large companies and make them more willing to divest under-performing divisions - thereby adding to the pool of businesses which could be bought by private equity. But deals generally will be harder to do, so private equity fund managers who want commitment, a cool head and clear focus from the management teams in the companies they back, will have to show these same virtues themselves in running their own businesses. Those who rise to the challenge should flourish.

Moving on ....

LGV has moved to a newly constructed building at One Coleman Street, London EC2R 5AA, near Moorgate in the City of London. We look forward to welcoming you to our new offices. To coincide with the move we changed our name from Legal & General Ventures to LGV to reflect not only the acronym by which we have come to be known by over the past twenty years, but also to better reflect our private equity activities. Our formal company name is LGV Capital Limited.

In just over a year, LGV has generated more than £320m of gross proceeds against a cost of less than £100m to investors through the sale of three investments ......

Tragus sold for £267m

In December 2006, Tragus was sold to the Blackstone Group for £267 million. This represented a profit of about £150 million and a return in excess of 5x cost to the LGV 4 Fund over less than a two-year investment period. LGV had originally acquired Tragus in January 2005, for £90 million. Tragus is one of the largest operators of mid-market restaurants in the UK.

During LGV's period of ownership, as well as continuing the roll-out of its successful Café Rouge and Bella Italia brands, Tragus launched Ortega, an exciting new tapas concept. At the time of the sale it had over 160 sites across the country serving over 12 million meals every year.

With its strong brands, exceptional management team, good track record of organic growth and excellent prospects for future growth Tragus was an ideal IPO candidate. The fact that an alternative equally successful exit route presented itself in preference to pursuing an IPO, demonstrates the strength of the private equity sector as an asset class.

TRAGUS

Kingfield Heath makes £60m profit

In June, Kingfield Heath, an LGV 4 Fund investment, was sold to Electra Partners in a deal which valued the whole of Kingfield Heath at in excess of £150 million. This generated a profit of £60 million to LGV, representing a return of more than 3x cost over a two and a half year investment period. Kingfield Heath is a wholesale distributor of office supplies throughout the UK and the Republic of Ireland. The company operates from nine warehouses, including a state of the art central warehouse at Magna Park, near Leicester, and is supported by a Head Office in Sheffield.

LGV acquired Kingfield Heath in a MBO valued at £85 million in December 2004 backing the existing management team, led by Chief Executive Alan Barclay. At acquisition LGV introduced Richard Martin as Chairman.

During LGV's ownership growth was achieved through market share gain due to the combination of a highly efficient distribution network, broadening the product range and entering new market channels. The Company was also regularly featured in the Sunday Times Profit Track 100 survey of fastest growing private companies and sales grew by more than 20% during LGV's period of ownership.

Simultaneous with the sale, Kingfield Heath also acquired ISA, a leading computer consumables supplier. This acquisition brought together ISA's offering in the electronic supplies sector and Kingfield Heath's extensive expertise in office supplies to create a 'super wholesaler' with a combined turnover of £500 million. Kingfield Heath had secured exclusivity for the acquisition of ISA prior to LGV's exit, enabling the acquirer to conclude the acquisition of both businesses in a £250 million deal.

South Lakeland Parks sold for £125m

In November, LGV completed the sale of South Lakeland Parks ("SLP"), an LGV 5 Fund investment, to White Ocean Leisure for £125 million. This generated a return of more than twice its money in less than 18 months.

SLP owns nine lodge and caravan parks in and around the Lake District and Morecambe Bay regions. SLP predominantly operates the owner-occupier model, generating most of its revenue from the sale of caravans and lodges. It is one of the country's leading providers of timber-lodge units, a market which has demonstrated high growth over recent years. The company also maintains a hire fleet and a small number of touring pitches.

After successful investments in the caravan sector with Bourne Leisure, LGV had identified SLP as a potential acquisition opportunity and made contact with the owner. A prolonged sale process took place and the deal was recut on several occasions, but in June 2006 SLP was acquired by LGV.

The business offered several attractions to LGV: a high quality asset base with some unique locations; a market-leading position in the high margin, high growth lodge sector; and an opportunity to incentivise a management team with equity in their business for the first time.

SLP's existing management team, supplemented by a new Finance Director and Non-Executive Chairman set about changing the culture of the business. This included introducing a new structure and process to the decision-making within the business and empowering park staff to run the business on a day-to-day basis. During LGV's ownership a series of key initiatives were undertaken and successfully completed:

- Feedback programme was implemented, with questionnaires issued to SLP's staff, caravan, lodge owners and holiday visitors and a rolling programme of mystery visitors was instigated to ensure operational consistency and adherence to best practice.
- New accounting system was implemented throughout the company, on time and on budget, improving the information flows at all levels of the business.

Disposals

- Rebranding exercise involved changing the company's name from South Lakeland Caravans to reflect the business mix more accurately. The company's profile was lifted with a series of marketing initiatives and stories. The introduction of plastic daffodils at Easter to replace those which had already come and gone due to global warming, was featured on prime-time TV and other national media.
- £3 million investment programme to upgrade the quality of the parks' accommodation and facilities was initiated including new timber lodge developments, an indoor swimming pool, a children's play area, jetties, tennis courts and facilities for disabled guests.

LGV received several expressions of interest in acquiring SLP throughout its ownership and in the autumn of 2007 commenced a sale process. White Ocean Leisure, a privately owned leisure business, with a background in real estate, quickly emerged as the leading bidder backing the existing management team to continue to develop and grow the business.

Portfolio developments

Verna comes into focus

In July, Verna Group, the Bolton-based manufacturer and distributor of infection control medical products, completed a £42 million refinancing with Bank of Ireland. This allowed the LGV 4 Fund to recoup the cost of its investment in Verna, which was originally made in May 2005.

The Verna strategy has been based around a simplification of the group. Five businesses have been sold, most notably Verna Community Care, the domiciliary care business, which was sold to Direct Health and Careshop, the medical products distribution business, which was sold to Bunzl PLC in a £11 million transaction completed in December 2007.

Verna is now a focused infection control business and is a leading supplier to the NHS of disposable bedpans and ancillary products. Verna has recently opened a new office in South Africa, as part of its overseas expansion, and now supplies more than 40 different countries around the world with its products.

Craegmoor refinances

In September, Craegmoor completed the refinancing of its whole business securitisation with a £255 million bank facility arranged by the Bank of Scotland. The facility provides Craegmoor with a strong capital base, substantially reduces its ongoing debt service obligations and provides it with the flexibility to move to the next stage of its development.

The refinancing was successfully completed in spite of turbulent debt market conditions reflecting:

- Craegmoor's strong and improving operating performance.
- Quality of a diversified and substantially freehold property portfolio comprising 234 homes.
- Attractive growth prospects of Craegmoor in the long term specialist care market.
- Defensive nature of the long term specialist market and predictable cash flows.
- Strength and experience of Craegmoor's management team.
- Quality of clinical governance, IT and HR systems underpinning the delivery of care.

Ted Smith, Chief Executive of Craegmoor commented at the time: "This is a highly significant milestone for Craegmoor and illustrates the tremendous amount of progress that has been achieved in recent

years. As well as improving the quality of our estate, we have invested heavily in improving our clinical governance and HR platforms as well as in training programmes for our 6,700 employees. There are a number of exciting opportunities to grow the business both organically and through acquisition and the refinancing is an ideal platform from which to further strengthen our position as the leading provider of specialist care."

Jeyes has a busy 2007

It has been a busy 2007 for Jeyes and there has been significant progress on a number of fronts.

Jeyes' strategy of moving production to lower cost countries has continued and the group has now opened a purpose-built facility in Kadan in the Czech Republic. Manufacturing in Germany has been transferred to Kadan with the German site now closed, and a number of operations from Mold in the UK have also been relocated. Following detailed planning this significant restructuring was completed to plan without any significant operational difficulties. This follows the successful opening of a manufacturing site in Mexico in 2003 and its subsequent expansion in 2005.

Jeyes also continued its simplification of non-core operations. Following the disposal of the firelighters business in 2006, in October 2007 Jeyes disposed of the Wet Ones brand to Energizer Corp. Whilst Wet Ones had strong distribution, the business had limited overlap with the remaining Jeyes business and Jeyes was able to achieve a competitive price from a strategic purchaser. Jeyes has also completed the sale & leaseback of two sites.

These various actions have resulted in a substantial deleveraging of the business and we believe that Jeyes is now well positioned for additional growth driven by the core UK brands and a well developed New Product Development programme.

Finally, Jeyes has invested significantly in supporting the core UK brands through sponsorship of the ITV show "The Bill". The sponsorship has been well received by the trade and this together with a television campaign behind the new product launch of Bloo Fusions, has contributed to strong year-on-year growth for the UK business.

As a result of these initiatives Jeyes has been able to reduce its debt to approximately 1x EBITDA.

Integrated Dental Holdings continues its expansion

In April 2006, the LGV 5 Fund acquired a significant shareholding in Integrated Dental Holdings ("IDH"), the largest privately owned company managing NHS dental practices in the UK. Headquartered in Bolton, IDH manages more than 190 dental practices, 750 dentists and treats around 1.5 million patients.

Since the acquisition, LGV has strengthened the management team with the appointment of a Chief Operating Officer and has opened or acquired 48 new dental practices, housing 140 additional NHS dentists and treating 300,000 new NHS patients. In July 2007, IDH acquired Orthoworld, a specialist orthodontic provider, which facilitated IDH's entry into the specialised dental market. The orthodontic market has strong growth forecast due to the limited treatment available under the NHS and the shortage of such services. This provides an opportunity for IDH to assist in improving access to NHS services together with development of the private revenue in this field. Orthoworld provides a platform from which to drive organic growth through cross-referrals amongst the Group's practices together with synergies and diversification into specialist markets.

The dental market is highly fragmented, with IDH representing less than 4% of the NHS dental segment of the market. IDH is well placed to continue to benefit from the consolidation opportunities with a strong pipeline of acquisitions in general practices and developing a similar pipeline in specialist fields to support this growth.

Integrated Dental Holdings

LGV operates across four key sectors and our experiences in each are described below:

LGV at Leisure

LGV has been a particularly active investor in the leisure sector in recent years, having made new investments in eight different companies since 2000. Only two of these investments, Bourne Leisure and South Lakeland Parks, have been in the same sub-sector of leisure (caravan parks) as LGV has also invested in pubs, restaurants, cinemas, country clubs, health & fitness clubs and casinos.

Despite the variety of business sub-sectors, all of the leisure companies in which LGV has invested exhibited attractive growth opportunities, accompanied by highly defensive business characteristics. For example, Café Rouge (part of the Tragus group) represented a strong brand proposition and Vue Cinemas held a key market position in a sector where scale counts. In addition, The Unique Pub Company, The Club Company, Bourne Leisure and South Lakeland Parks all benefited from high quality asset-backing. Finally, all of LGV's leisure investments have been highly cash generative, which has often enabled us to pay down debt ahead of schedule.

Since 2000, LGV has invested an aggregate £280 million in eight leisure sector deals, generating total realised gains of £584 million, with an average IRR of 39%. LGV still holds an investment in Total Fitness, the operator of 24 health & fitness clubs in the UK and Ireland.

Consumer Sector - an evolving focus

LGV has a strong track record as an active investor in the consumer sector. For those investments that have exited in the sector, LGV shows an average money multiple of over 3x and an IRR of 45%. Since 2000 LGV has held investments in such businesses as Jeyes, the branded household products manufacturer, Accantia, the owner of the Lillets and Simple brands, Young's Bluecrest, the seafood processor, and Golden Wonder, the snacks manufacturer. A common theme to these investments has been branded manufacturers selling into the multiple retailers. LGV has had success with these businesses by investing in brands, restructuring manufacturing operations and growing market share. However given the broad range of the consumer sector we have been reviewing more opportunities outside of the FMCG sector which represents our "heritage".

The areas where we believe there will be strong opportunities over the next few years will be those that are benefiting from key consumer trends such as fresh/organic/healthy foods, direct retailing, luxury/branded goods, leisure/outdoor/niche retailers and consumer financial services. Therefore whilst we retain our focus on the FMCG sector we recognise there may be a range of targets and categories within the wider consumer sector in the near future.

Invested in Healthcare

LGV identified the healthcare sector as an area of potential interest in 2000 and has developed a strategy of identifying sub-sectors which are likely to see significant levels of corporate activity and growth. In particular, we have invested in residential care homes through Craegmoor in 2001, medical consumables through Verna, private acute hospitals through Classic in 2005 and dentistry through IDH in 2006.

Healthcare has attracted strong interest from the private equity sector, with in excess of 70% of healthcare deals in the mid-market completed in 2007 involving private equity. LGV is particularly attracted to the favourable long-term macro-economic and demographic drivers of the healthcare sector. A growing ageing and affluent population, together with an increasing awareness of health is driving

demand in the sector. In addition, the sector remains highly fragmented, and this provides the opportunity to create value through consolidation. This marries well to the investment attributes LGV is attracted to: well established businesses in growth sectors.

In each sub-sector LGV has seen significant levels of activity following our acquisitions. LGV has experienced the

benefits of consolidation across its healthcare investments: since investment by LGV Craegmoor has acquired 86 homes; Classic acquired a tenth hospital, a private acute facility in Liverpool, in July 2006; IDH has opened 48 practices, both through greenfield development and acquisitions.

Healthcare remains a core sector for LGV in 2008. We will continue to look at investments in the medical consumables and devices space together with healthcare services. We will also consider the wider healthcare market, including the pharmaceutical sector, with a focus on specialised products and services

Services – a broad church

The UK services sector is a very important sector for LGV, and one which has experienced growth and expansion over the last decade reflecting the continued shift away from manufacturing in the UK. Whilst it is an extremely broad sector, LGV is focused on the following sub-sectors: consultancy services, outsourcing services, education services, logistics and distribution, and facilities management.

Historically LGV has made a number of successful investments in the sector including Hayley Conference Centres and the Earls Court & Olympia Group. In terms of identifying opportunities for LGV in this large space, we continue to revert to what we consider to be the key attributes of any LGV deal, namely a well established business, with a strong market position operating in a market with growth potential. In 2007 LGV successfully disposed of Kingfield Heath, a business which displayed these key characteristics. In 2008 we are looking forward to making further investments in this exciting growth sector to build on our existing services sector investment, LGC, an inspection and testing business.

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