A chill in the air

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From left: *Mikael Burelo, Bjarne Lie, Per Olofsson, Graeme Gunn and Kristoffer Melinder*

Excess liquidity is making it harder and harder to put capital to work in the Nordics, and, as Isobel Markham discovers, the region is bracing for more headwinds

PHOTOGRAPHY BY GORAN EKEBERG

It's a bright and crisp October afternoon when *PEI* arrives at Nordic Capital's Stockholm headquarters to meet with some of the region's most illustrious private equity specialists. But underneath the dazzling sunshine there's a brisk wind, signalling that soon the long nights will close in on the city.

And the consensus around the table is that it won't be too long before that chill settles over the private equity industry. With so much capital flooding the market, driving entry prices higher and higher, the panel has no doubt that the end of the cycle is near.

"I was almost a bit scared by the response we got from the LP community this time around," says Bjarne Lie, managing partner at direct secondaries house Verdane Capital.

Verdane, which, Lie says, has historically struggled with fundraising "because we were new and different", held a first and final close on its ninth Northern European-focused fund on SKr3 billion (€320 million; $355 million) in July after just four months.

"[We] could have done at least double the fund size, it was a self-imposed hard-cap," Lie adds.

"You can interpret that in two ways. You can say, 'Hey, we're an incredible team with a good track record', which I think we are, but what we talk a lot about internally is you can interpret it as, 'This will be a horrible vintage' across the industry, because it is almost too easy to raise money – and that leads to too much capital chasing too few opportunities."

Graeme Gunn, head of investment monitoring at SL Capital Partners, agrees that 2015, 2016 and perhaps even 2017 will be much tougher vintages than 2011 and 2012.

"As an investor we have to keep in the market, but we're definitely mindful of that when we're making commitments today," he says.

As a signal of just how much cash lies in the hands of LPs, SL Capital has recently been approached by several UK funds »

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>
> Kristoffer Melinder

» which are double the size of their predecessors. The firm turned them down.

"The dynamic here in the Nordics feels much more balanced and people are willing to not be overly excessive and not take all the capital they're offered in a fundraise. I'm pleased to see that and hear that, because there are other markets where that discipline's gone," Gunn says.

Managers in the Nordics may be more disciplined when it comes to fundraising, but that's not insulating them from the difficulty of putting capital to work in an environment of ever-higher prices. In 2015, private equity funds invested €6.3 billion in the Nordics, around €2 billion less than in 2014, according to data from Norwegian state-backed asset manager Argentum.

"Finding the right, attractive opportunities to deploy capital is probably the biggest challenge," says Kristoffer Melinder, a managing partner at Nordic Capital.

"We have worked extremely hard to find the right deals this year, but it has seen the lowest deployment of capital in many years. This has certainly not been through lack of trying, but because the price environment has been very tough. It is a sign that people are perhaps not factoring in the possibility of multiple contraction."

Melinder says his firm has been monitoring its pricing levels, trying to keep risk and growth at the same level as 2014 and 2015, and has been outbid by 15-20 percent.

"Some of the investments that Nordic Capital has declined may go on to do very well, but I think on the whole, it is safe to say that we are nearing the end of a cycle."

Investors, too, are concerned at the lack of deals, not just in the Nordic region but globally.

"Something has to change," says Gunn. "All our funds we're invested in have been in exit mode now for three years, so everything has been pushed out the door. So we're past peak value on exit, but we're still seeing an increasing volume and number of exits within our portfolio. When are the funds going to switch back to proper buying again and is there going to be the volume of opportunity there?"

A key competitor against private equity houses across Europe in recent years has been strategic buyers. Mikael Burelo, a partner in the transactions team at PwC in Stockholm, notes that private equity buyers have steered clear of structured processes.

"What we see is that there have been fewer structured processes in the market although activity has been high," he says. "There have been a lot of one-to-one processes. We see that [private equity firms] don't want to invest too much in diligence in an auction process, where strategics are [involved], as it can be difficult to compete on price."

Although strategic buyers are still playing a significant role in the region, Gunn notes that in recent months there has been a shift back in favour of private equity houses, resulting in a rise in secondary buyouts.

Lie agrees: "We historically have never really sold to private equity. But that has changed in the last couple of years, we've made a number of sales to private equity, and that seems to me at least a European trend that private equity is more aggressively bidding for growth-type assets."

"That's a sign that companies are staying private longer, and maybe that's a better environment for them to create the long-term growth as well," adds Per Olofsson, who heads the alternative investment group at Swedish state pension fund AP7.

"Looking at all the publicly listed markets, what are they doing? They try to generate as much cashflow as they can to pay dividends, or they will just buy back shares. Going forward, we will see the private sector growing fairly quickly because we can't go on investing into these companies who will only try to come up with higher dividends or share buybacks. They have to eventually start investing into growth. Private equity firms are much more suited at doing this."

That hunt for growth is the thread that runs through the whole discussion: how do you consistently generate alpha when the wider environment is against you?

Burelo has noticed private equity houses straying below their target size bracket, rummaging for those hidden gems that, with the right partner, can be portfolios' crowning jewels.

"As a general rule, if dealflow is not so good, you see the larger PE funds going down in size. Also, EQT has starting a venture fund this year and IK has started a small-cap fund. But that's not shifting focus down the size spectrum, it's rather broadening the scope for investments I would say."

There's a mixed reaction around the table as to whether larger players broadening their strategies is a good thing.

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Mikael Burelo

"We see the bigger houses growing even bigger, they do everything from small, mid, large buyout, they do venture, growth, credit, infrastructure, they might even do some property funds. And of course if they can use the benefits of scale, that could be positive," says Olofsson.

"On the other hand it also squeezes out the smaller new entrants. Unfortunately I think we will see fewer and fewer new entrants, and that partly has to do with the pressure for compliance and transparency. There's definitely a trend where you see larger players taking more and more of the capital. I saw some statistics only a couple of weeks ago that of the global fundraising, 20 GPs took up 35 percent of the commitments. And it's been creeping up."

Nordic Capital has yet to launch any new strategies alongside its core buyout funds. But market conditions have pushed the firm to invest in its own toolkit for driving growth.

"We have made significant investment to develop Nordic Capital's value creation processes, focusing on investments where there is real scope for growth acceleration," Melinder says. "I think the whole industry has to focus on how we actually drive and accelerate growth. Against a backdrop of macroeconomic challenges, it is typically through growth that the industry will achieve strong returns and find the alpha."

All agree the vibrant tech scene in the Nordic region is a rich hunting ground.

"Do you know what the most common occupational title is if you look at the Stockholm demographics? It's programmer. Fifty thousand people have programming as their job. It's an extremely innovative and fascinating economy here in technology, broadly defined," says Lie. »

» Even though the shift toward generating returns through value-creation initiatives has been driven by a tougher market environment, the change is "embedded", says Gunn. Even if there is a big market correction, the industry will continue on this path, he argues.

"The funds have become more industrial and focused on generating real growth. If you look at any diligence – and we co-invest, so we see the diligence that runs on a number of deals – the post-deal strategy typically now runs to 20-plus individual projects over a business. It's incredible the depth that goes into it."

This intense focus on seeking out growth opportunities naturally means that origination is more important than ever.

"When we're doing diligence today, the biggest part of our work is around origination," Gunn says. "What are you doing that's going to get you ahead of the competition? Where are you looking? Are you looking at the impact of digitalisation and disruptive models? What's going to be the advantage going forward from today? Because we firmly believe that the world will get tougher in the next five years, and everything we do today is with that mentality."

Lie's team, he says, "talk a lot" about origination.

"Last year we had 1,541 outbound deal-sourcing meetings. We organise what we call SWAT teams – special weapons and tactics teams – by country and we try to be quite disciplined about identifying the right situations and the right assets for us," he says.

Rather than a particular focus on sectors, Gunn is seeing funds become more specific about the type of business model they're targeting, such as subscription-based models.

"Sector-specific, it's just tough in Europe given the different countries and regulatory [regimes]. I think it will be an evolution in the European market, but it's 20 years down the line before we get there."

However, when selecting businesses that have a high potential for growth outside their home region, there are some industries that, as Melinder puts it, "travel well".

"Healthcare is a sector that travels more easily than other sectors. There are more similarities between healthcare businesses than there are differences between the countries in which they operate."

Financial services also shares this characteristic, to a lesser extent, which has not escaped the notice of private equity houses.

"The financial services sector is also interesting from a private equity perspective because there's only a few local PE houses here that actually invest in financial services, but now it seems like everyone wants to get in because there have been and still are a lot of opportunities in the sector," Burelo says.

"There have been a lot of niche banks established that have challenged the traditional banks, and they have grown to decent sizes. In addition, we have the deleveraging of the traditional banks. So I think it's still a lot of opportunities in that sector, and a lot of other local PE houses would like to get into that sector."

In recent years, private equity in the Nordic region – particularly in Sweden – has had a rough ride, enduring criticism from the government and the public alike on the back of investments into the welfare sector.

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> **Bjarne Lie**

The industry, our panellists agree, has responded well.

"The Swedish industry has had the toughest time, and my impression certainly, from the outside, is they've done a very good job stepping up to that challenge, both through the association but also through the leading firms taking a much more visible role in society and allowing the most access," Lie says.

There's also a consensus that, despite being subject to some of the harshest criticism, GPs operating in the Nordic region are far ahead of their counterparts in other parts of the world, because of the way Nordic society is imbued with environmental, social and corporate governance concerns.

"It's starting from a slightly different base," Lie says. "A lot of these things we have been brought up with, it's the licence to operate here."

Olofsson agrees: "In the Nordics there is a different mindset. People in general tend to care more about the environment and ESG factors, and we have a lot of pressure on us as a public pension fund to do more and more on this side. Of course you can wish for more, but we see things moving in the right direction. I would say the Nordics is an excellent example of this compared to the US programmes that we're in."

However, Olofsson is quick to point out that the work is far from done.

"You have to make a distinction and ask yourself 'what is the public opinion, and what is the reality?' For the GPs, the one who sticks out his neck the furthest will also be hit back on the hardest. Things are gradually moving in the right direction, but we as LPs, together with GPs, will have to keep on pushing this further and further and demystify the myth around private equity. But it's not going to be a quick fix, it's not going to change overnight. We'll gradually get there."

One recent trend that is going some way towards banishing the idea of the private equity baron sequestered on a desert island buying up companies and not giving back to the community is domiciling funds onshore.

"We always had our funds in Denmark actually, but we moved our latest fund to Sweden," Lie says.

"I think although the real tax difference isn't that large, it's a perception issue that's quite important. If that regulatory framework proves stable so that becomes the trend, I think that also removes a lot of the branding challenges the industry has."

Nordic is also intending to domicile its next fund in Sweden. Burelo confirms that the trend is widespread.

"We have noticed a larger interest in onshoring from our private equity clients, which seems to be a direct response to the discussion about tax planning in media," he says. "And from a tax perspective, the implications from having a Swedish domiciled fund compare to an offshore fund is quite similar."

Our panel is certainly positive about the Nordics' future, especially compared with other markets, pointing to the stability of the region both politically and economically, and the consistently good returns it has delivered for the industry.

"Sweden is the one country in the OECD that actually decreased its government debt to gross domestic product »

> *There's definitely a trend where you see larger players taking more and more of the capital*
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> **Per Olofsson**

» during the financial crisis. Norway, until recently, has been a very strong performer," Melinder says.

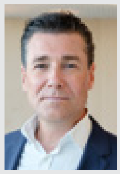
"Of course, as Swedes, we know the signs of a highly leveraged economy, and household debt to GDP is at a high level, from lessons learned in the early 1990s. But even if you do stress tests and so on, the Nordic economy is in fairly good shape. Despite what was considered a big shock last year following the refugee crisis and the resulting cost to society, we can see one year on that the economy has in fact managed to handle this fairly well so far. The scaremongers have been proved wrong."

But they all agree that the tide is turning, and the next five years will without a doubt be tougher than the previous five.

"Our biggest concern is that we've had such a great run now that I'm worried we will fail because of that. Success breeds failure in a way," Lie says.

"About a third of our team was not there for the last big bang, and the world feels a bit now as though it's a boat with too much water in it, all that liquidity sloshing around. In our organisation and in the private equity world in general we're underestimating risk and volatility. I'm worried we will lose our paranoia." ■

MEET THE ROUNDTABLE



PER OLOFSSON
Head of alternative investments
AP FONDEN 7
The seventh Swedish National Pension Fund has SKr305 billion ($34 billion; €31 billion) of assets, of which 3 percent is invested in private equity. Olofsson has been with AP7 since 2002.

KRISTOFFER MELINDER
Managing partner
NORDIC CAPITAL
Melinder joined NC Advisory, advisor to the Nordic Capital Funds, in 1998. He has mainly been active in Nordic Capital's healthcare franchise, including investments such as Nycomed, Dynal Biotech, Biovitrum, Altana Pharma, Atos Medical, and ConvaTec. He is currently working with GHD GesundHeits, Lindorff, AniCura and Greenfood.

MIKAEL BURELO
Partner
PwC
Burelo is a partner in the PwC Sweden Transaction Service Group. He has more than 17 years' experience in the practice. He is an experienced leader on PE due diligence assignments and has worked extensively with a large number of the Nordic private equity houses on a broad range of transactions.

GRAEME GUNN
Head of investment monitoring
SL CAPITAL PARTNERS
Gunn is based in the Edinburgh office and joined SL Capital in 1999. He has been instrumental in building the firm's secondaries investment capability and is responsible for overseeing primary fund investments and direct co-investments. Gunn has particular focus on the Nordic markets and serves as an advisory board member on a number of European private equity funds.

BJARNE LIE
Managing partner and chief investment officer
VERDANE CAPITAL
Lie joined Verdane in 2001 from PaperX, of which he was co-founder and chief operating officer. In his early career, he was a consultant at McKinsey & Company and a research associate at the European University Institute in Florence.