



Roundtable: Calm before the European mid-market storm

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Increasingly perceived as a steady ship in a sea of volatility, investors are clamouring to get into the European mid-market, but they should beware of clouds on the horizon.

Post-global financial crisis, Europe was not high on most investment committees' lists of desirable investment destinations. Individual economies within the eurozone were imploding and a possible break-up of the union loomed large.

Fast-forward eight years through a crash in the Chinese stock market, a hike in interest rates by the Federal Reserve, tumbling commodity prices and free-falling currencies across Latin America and sub-Saharan Africa, and Europe is looking quite rosy.

“Five years ago when I was fundraising in the US, the Middle East, in Asia, everybody was looking at Europe as [if it were] something terrible that would explode. They had no confidence at all,” says Philippe Poletti, head of mid-cap buyout at Ardian.

“Today they are much more confident. We don't have much volatility and that's probably what our investors like.”

It's a great time to raise a Europe-focused private equity fund. Two years of record distributions back to investors – \$477 billion and \$502 billion in 2014 and 2015 respectively, according to data from advisory firm Triago – means LPs globally have plenty of cash burning a hole in their pockets.

“We're seeing a steady flow of significant distributions, which we are returning to our investors, which is then trying to be redeployed back into the industry,” says Mark Nicolson, a partner at SL Capital Partners.

“Particularly because of the low returns you're seeing from the other asset classes – equities, bonds, etc. – investors are chasing exposure to PE to be able to deliver what they need to deliver to their pensioners or stakeholders. Private equity is in high demand, and that's why we're seeing success at almost all levels.”

Several macroeconomic factors within Europe itself have helped drive investors to the region, says Poletti. “The macro environment is very good for European companies. It is the first time that we have a low euro, a low price of oil, low interest rate, and most of our companies are benefiting from this environment. Portfolios are doing extremely well.

“You also have other regions that are not doing extremely well – Asia, Middle East, South America – so most of the money is flowing now to Europe that has shown, on a macro level, stability. On top of that, we went through the crisis and most of the funds did extremely well, so we have shown that LBO activity was not that risky.”

There was only a slight uptick in the number of Europe-focused buyout funds closed in 2015, 31 compared with 30 the year before, according to data from PEI Research & Analytics. However, total capital raised almost doubled from \$23.7 billion to \$42.9 billion.

“There have been very few casualties,” Nicolson says of the fundraising market, adding that in some cases funds are even resetting their hard-caps. Increasing the fund size in the face of enthusiastic investor demand is something few managers can resist.

“I think it is, in most cases, too tempting for the GP when they've got significant demand,” Nicolson says.

The participants agree that a certain level of growth is a good thing – after all, as Poletti points out, standing still and not evolving is also a worry. But how much is too much?

“If a fund's size goes up 10-25 percent that's probably acceptable, but if it rises, as we've seen in a few funds, 60, 70 percent in size, that starts to suggest a marked change in strategy,” says Malcolm Hassan, head of funds and asset management sector at Royal Bank of Scotland. “There's a manageable amount you can do, and I think it's a really healthy part of growing and developing.”

Nicolson adds: “From an LP perspective, you need to have certainty of deployment, and if managers are raising a larger fund it means either they're going to have to do more deals, or they're going to have to write

bigger equity cheques. You've typically backed them before based on a certain strategy, and if the revised strategy, because of an increased fund size, takes them to a different part of the market then you have to reassess the proposition."

Hassan agrees. "A change of investment strategy is the most worrying part," he says. "What the investor community doesn't want to see is a fund manager stretching too far either geographically, sectorially or size parameters of the underlying investment. That just gets me, as banker and follow-on investor, uncomfortable. Most investors and funds bankers want predictability. We like growth, but don't do something that is going to unsteady that predictable ship."

GPs need to be clear whether a substantially larger fund means a larger equity cheque or more businesses in the portfolio, and address their internal workload management and responsibility distribution accordingly, says Bilge Ogut, managing director and head of private equity Europe at Partners Group.

"Whether there is the right set-up to be able to deploy the money responsibly and prudently, and at the same time meet the return hurdles, would be an important part of an LP's decision to say yes to that," she says.

Tom Salmon, a director at 3i Group, agrees: "It's about asking GPs for the discipline that we would ask of our portfolio companies."

INCREASING COMPETITION

The glut of exits in 2014 and 2015 which made for such a buoyant fundraising environment is, says Hassan, a double-edged sword: "This year needs to really see a step up in deployment to make sure that investors' money commitments are converted into money deployed to get future results."

A relatively stable Europe has resulted in a significant number of new market entrants, making winning deals tougher than ever, especially in the mid-market which, historically, has outperformed the large-cap space.

According to data from trade body Invest Europe, the pooled average internal rate of return of European private equity funds raised between 1990 and 2011 is 9.1 percent. For mid-market funds specifically that jumps to 17.2 percent.

However, it is not just new private equity firms or non-European managers taking an interest in the region.

"North American GPs have had appetite for European assets for some time, I don't think that's necessarily new," Ogut says. "I think the last couple of years have been much more about Asian and North American corporates being very active in Europe."

Poletti agrees: "US and Asian strategics are our biggest competitors. The euro is low at the moment, so for them it's great value buying assets in Europe. Family offices are [also] getting bigger and buying assets

even up to €1 billion.”

There has also been a notable increase in sovereign wealth funds and pension funds investing directly.

“There is definitely more capital in the market,” Ogut says. “The mid-market continues to be interesting to them because the growth prospects seem to be better than other geographies which they really thought were high growth, [such as] emerging markets [which] are not bearing the expected fruits in some cases. That did bring some attention back to Europe.”

Hassan and Nicolson have both seen an increase in managed accounts, which have contributed to mounting competition in the mid-market.

“We’re seeing the existing same GP effectively having an increasing number of fund vehicles deploying through their infrastructure,” Hassan says.

PRICING

Increased competition naturally has a knock-on effect on pricing, making it a great time to sell but tough to put capital raised to work. While the participants agree that valuations in Europe are high, Ogut’s sense is that prices are not rising as steeply as they are in the large-cap space, in part because of the financing markets. “Mid-cap companies are still, on balance, harder to finance than the large-caps where there are more financing options available,” Ogut says.

As Hassan points out, full valuations are not always unwarranted: “We saw the average earnings multiple edge closer to 10 times in 2015. Ten times is not that high for a really good quality business underpinned by sustainable earning dynamics. Increases in market multiples can be misleading, but ultimately it depends on the quality of businesses that are getting bought and sold.”

Poletti agrees that within the context of today’s interest rate environment and global growth statistics, private equity firms are better off even though multiples are higher.

“When we used to pay six times EBITDA we had much higher interest rates. Paying 10 to 12 times for a business that is growing at 10 percent when the global market is not growing, and with a very low interest rate, is quite normal.”

A plethora of new debt providers entering the market has meant liquidity is still very strong. However, Nicolson and Hassan say managers and banks thus far have been restrained.

“The pain that was experienced 10 years ago was unbelievable,” Hassan says. “The approach taken not only to cyclical sectors, to hold levels, use of covenants, the leverage levels that are being deployed, the use of run-rate EBITDA, multiples, the whole approach now, certainly from the leverage world, is radically different.”

STORM CLOUDS AHEAD

That is not to say that the next few years will be smooth sailing for the European mid-market. In fact, the participants unanimously agree that a downturn is on the way.

“We will have another crisis,” Poletti says frankly. “Cycles are reducing, so we could have a crisis every three years. Our job is to make sure that we’re taking that into consideration in our models, in the debt that we put in. Probably one of the big changes in our job is that having five years in a row without issue might be difficult in the future.”

Hassan adds: “[The market] will turn, the question is when and whether or not the cycle will effectively speed up. Standard deviation from the top to the bottom actually might be a little shallower. Ultimately, I think and hope it will shorten from the typical 7-10 years and be a little less volatile going forward.”

While robust pricing will mean the environment for exits is likely to remain favourable, the exiting spree is expected to slow.

“What is going to change this year is that public market volatility will make listing less desirable as an option for exit,” Ogut says. “Many sponsors will be quite uncomfortable with the issues around volatility – both price certainty and listing certainty – and may prefer to get money off the table in a negotiated transaction. People are going to be looking for more deal certainty over price. But I think there are sufficient buyers for the exit climate to hold up overall.”

Salmon agrees: “The dynamics in terms of supply of capital, in terms of volume of competition, they are going to sustain pricing. Who knows exactly where it’s going to go, but I don’t see it being any less of an attractive market.”

In fact, any slow-down in exit activity is likely to be more of a concern for players at the larger end of the market, Poletti says. “[In the mid-market] you have more options at exit. If it’s already a big company, then who’s going to buy it?” he says, adding that the stock market has not been a clear exit path.

When asked about particular macro concerns for 2016, the panellists answer in one voice: “Brexit”.

Nicolson says: “Whether anything actually materially changes as a result of Cameron’s negotiations, there will be that period of uncertainty in the run-up to any referendum, so we may see dealflow subdued and people adopting a ‘wait-and-see’ approach. Realistically, I’m not sure anybody believes that Britain will leave, and so it may just be a lull in activity and then an acceleration thereafter.”

There’s also a consensus around the table that quantitative easing must continue to uphold economic stability and portfolio companies’ prosperity.

“Hopefully [QE] will be a lever by which we could actually ensure the continual upwards trajectory across Europe,” Hassan says.

For Ogut, the valuation of the euro is a major concern. “I’ve looked into a number of businesses over the past year where yes, there was some strength in the business, but most of that strength was coming from the relative weakness of the euro in FX markets,” she says.

“That becomes a concern if there is a reversal in FX trends that then threatens the stability of that business. When it becomes difficult to find businesses with inherent growth dynamics or global competitiveness, we suffer as a result.”

BOOSTING VALUE

The participants agree that managers will need to pick up the pace on deployment in 2016, and Poletti suggests that if the market doesn’t turn before the end of the year then 2016 could be “a big year in terms of volume”.

But with valuations expected to stay put or even continue to rise, investors are adjusting their expectations around returns.

“Pricing inherently has a knock-on impact on returns,” Nicolson says. “Where we were seeing relatively cheap pricing in ’11, ’12, ’13, I think ’14 and ’15 have all of a sudden become quite expensive vintages. From a returns perspective we’re certainly expecting those vintages to be, on average, lower performers.”

Managers, therefore, must not only buy well but buy with a plan. In the mid-market there are more opportunities for houses to differentiate themselves in a deal process, the group agrees.

“There are many different layers in terms of how you can build a business case with a strong management team, which could be less the case in large-cap,” Ogut says. “When you have to pay the price, you also have some assumptions reflected in that price about what you want to do with the business because of your prior expertise.”

One of the sectors in which 3i invests, for example, is consumer, which is often considered cyclical. However, pockets of the sector will be resilient through a downturn, Salmon says.

“For us it’s about being very, very disciplined about where we put money to work. You have to be able to compete in this environment, which does require paying a market price unless you can source off-market,” Salmon says. “You differentiate yourself by your footprint, the quality of your network, your expertise, the sectors that you look at and your people. Our differentiation comes from our history, our experience, our sector expertise, our extensive leadership network and our international footprint.”

3i looks at each investment across its core sectors of consumer, business services and industrials “through

a lens of internationalisation”.

“We invested in a business just before Christmas called Audley Travel, which is the UK’s leading tailor-made travel provider, and apart from it being a fantastic business and having a lot of heritage in the UK, a lot of the attraction for us was having a US presence, which was nascent, but where we saw the opportunity to add significant value through our network, whether that’s broadening the customer base or thinking more carefully about the digital opportunity.”

Creative deal tactics can also help managers secure assets at a fair price, says Salmon.

“We have equity underwritten a number of recent deals and then refinanced thereafter, and certainty and speed of execution has won us deals where we haven’t been the highest bidder,” he says. “When we’re looking at potential investment opportunities, we are certainly thinking about levers right across commercial, operational and financing.”

With today’s entry multiples in mind, the GPs around the table agree that old-fashioned leveraged buyouts won’t cut it.

“We have to be sensible, active shareholders who think very much about what the business will look like when we sell it rather than just arranging an attractive financing package to continue to own the business as-is,” Ogut says.

As with several of its peers, buy-and-build is a key tool Ardian employs to transform local champions into global leaders, says Poletti. “[With] the multiples we pay today, the only way to maintain the performance that we want to deliver to our investors is to be able to transform the business and to make sure that at exit the value is completely different. That’s not only by doing a small add-on, it’s doubling, tripling the size of the business.

“In the last five years we made 17 investments and 98 add-ons to those investments. In four years we increased the EBITDA by 70 percent in two-thirds of the portfolio.”

He adds: “An increasing part of value creation is made before we acquire a business. You need to have identified most of your build-up opportunities and approached them to make sure that they will be available.”

3i has seen success with a similarly transformative strategy, most recently with laboratory-based testing company Element Materials Technology, which it sold to fellow European player Bridgepoint in December, generating a 4.5x euro money multiple.

“That was a great example of private equity facilitating and supporting the complete transformation of a business,” Salmon says.

“We took it from \$18 million of EBITDA to \$80 million through a combination of organic growth and 10 bolt-

ons, and that was through understanding the sector and having a local presence in Element's key geographies. It's those types of transformational deals that actually then attract the next type of transformational deal because people see you have the capability to execute on it."

IMAGE ISSUES

Despite such examples of building and strengthening businesses, private equity still has a less than favourable reputations, something everyone around the table – and across the industry – has had to grapple with.

Hassan posits that regulations such as AIFMD – while burdensome for the industry, not least because of a lack of clarity around what's expected – could help to improve perceptions.

"There is a sense that having a regulated industry is actually a good thing. Its adoption in terms of third party oversight and transparency will probably be helpful in changing the perception of retail investors and the person on the street of the PE industry, but in reality it doesn't really change anything that private equity will do going forward."

Although industry trade bodies such as Invest Europe and the British Private Equity and Venture Capital Association have been making progress with highlighting the benefits the private equity industry brings to economies, Nicolson says the next step is to engage the wider public and increase understanding of the relevance of the industry to their lives.

"All pension funds have an allocation to private equity, so to all intents and purposes it's not just a few people's money, it's everybody's money that's involved in private equity," he says.

"Almost always, private equity is the highest performing part of their portfolio. I think if the wider population were more aware of that, that it's their money that's at work, building businesses and earning these returns, you could engage more in a conversation and bring people more on board with the asset class."

Hassan agrees: "That connectivity between the individual, the pension fund they invest in, which in turn invests in private equity is what is lost on most people. The average person on the street does not think they're connected to the PE industry at all, when in fact they are."

Despite its challenges, the sentiment around the table is that, at least in the medium-term, Europe is still the sunniest – and safest – waters for LPs and GPs to navigate.

"As a house we've got more confidence in Europe," Nicolson says. "I think because the US is that bit further down the cycle, we're viewing Europe as being an attractive place to be at the moment. I think there's always the question in the back of mind: when is it going to turn? And we have to consider this in the context of our portfolio construction."

AROUND THE TABLE

Malcolm Hassan is head of funds and asset management sector at Royal Bank of Scotland. His team supports fund managers with strategies across the alternative assets spectrum and the wider asset management sector operating in UK and Western Europe. Hassan spent five years with RBS's leverage finance team and nine years in M&A advisory with Rutherford Manson Dowds (now Deloitte) and British Linen Advisers.

Mark Nicolson joined SL Capital Partners in 2007 and is a partner based in Edinburgh. He is head of SL Capital's Fund Investment business and is also responsible for making secondary and direct co-investments in Europe. Nicolson is a member of SL Capital's investment committee and serves on the advisory boards of a number of European private equity funds.

Bilge Ogut is a managing director and head of private equity Europe at Partners Group, based in Zug. She is a member of the Private Equity Directs Investment Committee and the Private Equity Primaries Europe Investment Committee. Prior to joining Partners Group, Ogut worked at Standard Bank, Warburg Pincus and Goldman Sachs. She holds an MBA from Harvard Business School.

Philippe Poletti joined Ardian in 1999 and has led numerous deals. As head of the Mid Cap Buyout team he has overseen its development into a pan-European activity. Poletti's career began at Solving International, in 1994 he joined Desnoyers Group as business development manager, later going on to become a special consultant to the president. From 1997-99, he was head of mergers, acquisitions and divestments at textile group DMC.

Tom Salmon joined 3i Group's private equity team in June 2004 and is based in the UK, having also spent time working in the firm's Madrid office. He has responsibility for 3i's activities in the consumer sector in the UK, and sits on the board of Audley Travel — a transaction he led — Agent Provocateur and Hobbs.