UK ROUNDTABLE

Flight to quality

The UK is one of the world's most established private equity markets, long a magnet for talent and capital. But given its stuttering domestic economy, thanks in no small part to the troubles of the neighbouring eurozone, are there still opportunities for private equity to make great returns? We gathered three of the UK industry's leading lights in London in January to ask them about the outlook for 2013

PEI: Do non-European investors regard the UK as a distinct proposition from the Eurozone? Or is it tainted by association?

Sean: I think it's a northern Europe versus southern Europe distinction, rather than UK versus the rest of Europe – other than the currency. The extent to which we're not tarnished by association with the euro is, I would say, a good thing.

Mark: Currently we view the most attractive European markets as being the Nordics, Germany and the UK; that's where our portfolio is weighted. We've not really touched southern Europe for 10 years now but we continue to monitor the opportunity.

I think in the UK having the pound is an absolute positive, because the fund and transaction currency is not directly exposed to the uncertainty around the future of the euro. But it's also that the UK is the most established and sophisticated market in Europe; it's a great place to do private equity. The legal and advisory infrastructure is there; the managers are there; and management teams and corporates are very willing to consider private equity as a means to either buy or exit a business.

The other aspect is that the tax and legal regime that we have in the UK is »

THE PANEL

MARKUS GOLSER
GRAPHITE CAPITAL

Markus Golser is a senior partner at Graphite Capital. He has led and structured a variety of transactions since joining Graphite in 1997, including several in the retail and support services sectors. He also oversees Graphite's portfolio and finance functions. He started his career as a management consultant with Bain & Company, where he worked in Paris and London.

SEAN WHELAN
ECI PARTNERS

Sean Whelan is a managing director at ECI Partners, and a member of ECI's Investment Committee. Based in London, Sean has overall responsibility for ECI's exit strategy across the portfolio and post-investment added value. Sean's past and current investments include ClarityBlue, Bounty, Language Line, MM group, WCI, Harmoni, CliniSys, XLN and Wireless Logic. He previously worked as a strategy consultant for Gemini Consulting and Bain & Company.

MARK NICOLSON
SL CAPITAL PARTNERS

Mark Nicolson is a partner at SL Capital Partners where he is responsible for primary fund investments, secondaries and co-investments. He also leads the firm's coverage of the UK and German speaking markets. Prior to joining SL Capital in 2007, Mark spent 7 years working as lead advisor in the Corporate Finance teams of Ernst & Young and KPMG, focusing principally on buyouts. He is a member of the Institute of Chartered Accountants of Scotland and a Fellow of the Chartered Institute for Securities & Investment.

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» conducive to private equity. It's a distinct advantage so I would not like to see the government tamper with that.

Markus: In the US, in particular, some investors see the UK as being the best place to continue with a European programme – because of how liquid and large the market is by comparison with others, and also because of how easy it is for them culturally and linguistically to understand what's going on.

Some investors clearly buy the argument. Despite what's generally agreed to be a very difficult fundraising climate, there have been some conspicuous successes for UK-based firms in recent months. Why is that?

Mark: There's been a definite flight to quality in terms of the funds that are closing quickly. These managers typically exhibit a number of key qualities including stable, high quality teams and a great track record through the cycles. In many cases, they also have the capability to really take advantage of the current opportunity via a strong sourcing model, the ability to take on more complex deals and the operational skills to fundamentally change and improve the businesses they acquire.

Sean: It's also about continuity of the team. If you have the experience of working across multiple cycles with multiple funds, I think that must give a lot of comfort to investors. They know you've been there, made the mistakes and moved on – which is influencing the way you deploy capital now. For instance, our experience of the last recession meant that when we were quite slow to deploy capital after 2008, we weren't worried – we knew we just needed to wait for the market to come back a bit.

FINDING DEALS

Economic growth in the UK has largely flat lined since the crisis. Are there still good opportunities to be found?

> ***An export angle is not a prerequisite, but it's certainly an interesting added area of growth***
>
> **Sean Whelan**

Mark: In any economic circumstance there is opportunity for private equity, and that's certainly the case within the UK. You've got some of the smartest people in the world within the industry – so the ability to find opportunities and create value is there.

There are some fundamentally solid businesses that have perhaps fallen on hard times, been under-managed or just have a poor capital structure – but if you have the ability to fix those then you can make an attractive return.

Markus: When we see our LPs, they rightly focus very strongly on how we've adapted to the recessionary environment. How a GP performed in the boom years is somewhat irrelevant in the current environment – because, these days, value creation is a completely different game. So almost any conversation you have with an LP focuses very much on: 'Tell me about the investment opportunities you've identified after 2007; tell me how your post-recession investments are performing; tell me about your value creation strategy in a difficult economic environment; and tell me about how you are making these businesses better.' Because the time when you could just buy and sell is long gone.

Once you are able to explain how opportunities exist despite the macroeconomic context, the more sophisticated investors in North America, particularly, find that very credible and interesting. And I think that also helps you get over some of the perceived prejudices especially from non-European LPs who see Europe and the UK as a bit of an economic basket case.

What are the most attractive industries or opportunities in the UK at the moment? Is some kind of export or internationalisation angle a *sine qua non*?

Markus: Within the UK there is very clearly a London economy and an economy everywhere else in the country – and some of our investments have been very heavily focused on exploiting this. So for instance, we backed a restaurant business called Rex, which owns the Wolseley, that is exclusively based in London and we launched a housebuilder, London Square, focused on London property development.

Outsourcing in a variety of guises has also been a very strong sector to back – with both public and private sector organisations outsourcing to specialised service providers. I think the UK has actually been very successful at exporting that model to other countries: for example, our recruitment process outsourcing business, Alexander Mann Solutions, has been highly successful in gaining multinational clients in different geographies.

I think international expansion potential is harder to fulfil – it takes longer to build credibility in overseas markets – but you can nevertheless successfully export strong consumer and business service propositions abroad, as we did with Kurt Geiger, a footwear retailer.

Sometimes, too, you're able to identify relatively small manufacturing businesses that have actually built strong international exposure: we backed a company called U-POL, which is an automotive refinishing products manufacturer, and that business has distribution in 120 countries despite being still small enough to be a midmarket investment.

Even with retail: it's a huge sector and there are very evidently winning business models – so it's not a sector we would discount just because of the economic context. However, you have to bear in mind that it's a sector that doesn't currently attract a lot of bank debt. And therefore they have to be businesses that are capable of growing fast organically, in order to offset the lack of leverage.

Sean: I don't think any of us are looking at backing the market; we're looking for the niche opportunities, the underlying growth trends. One of our themes is technology businesses that help clients save money. So we backed a company called Fourth, which provides back office software to restaurants and pubs to help them manage their cost base. That business has shown very strong growth in the UK, and we recently made an acquisition to take it into the US.

Another theme would be markets that are not obviously growing, but where there's a shift in the way people do business. We backed a business called CarTrawler, which is a car rental aggregator. The car rental business globally is not growing, but CarTrawler is the fastest-growing business in our portfolio: it delivered just over 40 percent profit growth last year organically, because it has a global addressable market.

It is possible to make money with UK-only based businesses. About a third of our portfolio is UK-only, and that tends to be service-based business models that have a large enough addressable market in the UK – so you don't need to take the risk of going overseas.

However, about a third of our portfolio has more than 50 percent of its revenue overseas. So it's not a prerequisite, but it's certainly an interesting added area of growth. And by backing businesses that are based in the UK, they're growing within a stable legal and business framework that we understand – which we think is going to de-risk the international expansion.

Mark: It all depends on where you are in the market. At the small cap end, or the lower end of the mid-market, there is more likely to be a sufficient addressable market within the UK to sustain a business and make a »

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> **Mark Nicolson**

» good return – and then perhaps pass it on to the next guy who can take it international.

However, with the advent of e-commerce, you are seeing more and more small businesses becoming international; you can have a small consumer product manufacturer based in the Midlands that sells to Japan. So if there is the right expertise within the manager, taking a business global is a lot less effort than it used to be.

There are deals to be done across all sectors in the current environment. You perhaps have a raised eyebrow when somebody is doing an automotive or a retail deal – but you need to drill down to see what the underlying quality of the business and market opportunity are.

The one sector I would potentially add is energy. We have seen a step-up in the number of energy deals being done by generalist managers, and there are obviously a lot of specialist energy managers raising money hand over fist at the moment. And that is a very attractive sector. The fundamentals are there, given population and income growth globally; demand for energy and natural resources is only going to go in one direction.

DEALING WITH BANKS

What's the state of the lending market in the UK at the moment?

Sean: We're a growth-focused investor. So we've never wanted to over-lever a business, because that gets in the way of investing in growth. And the banking market since 2008 has actually been quite conducive to that – we're not looking for extreme leverage and the banks are not offering it.

But for us – and we've tended to deal with traditional high street lenders, at least so far – the banks have remained open for business. There is definitely a flight to quality in the sense they've learned some lessons themselves – and that is probably a good thing, because I think it helps the market weed out the bad opportunities. But for good opportunities – particularly businesses that have a combination of growth and resilience – then banks are quite keen to lend, albeit at historically modest multiples.

We haven't seen banking as a constraint at all. And we've been telling vendors that a lack of banking is no reason not to sell their business – because if it's a good company, they'll be able to get it away at a good price.

Markus: It's not been a constraint for us either. In fact I agree that the situation has actually been very helpful, because the bankers have switched their brains back on. We deal with people now who are very experienced; who have clearly lost quite a bit of money over the past few years and are therefore scrutinising opportunities alongside us. So it's a much more thorough due diligence process from their side, which is very helpful for us.

I also think that, if you've been operating in this market for quite a long time, you have established relationships that, at this particular point, act very strongly as a differentiating factor. There have already been cases (and I think there will be more) where we have been able to raise debt where others can't. In that sense, you could actually say we're quite satisfied with the status quo – with the possible exception of the fees that they charge.

Mark: I think from a banking perspective there has also been a flight to quality. What we're seeing is it's fundamentally down to the underlying asset. If the quality is there, you can get it funded – albeit at lower multiples. Average equity percentages within the capital structure are clearly up which has an impact on potential returns.

We've also seen a number of situations recently where GPs have gone to sell businesses and they haven't been able to reach the return that they wanted; so they've taken a step back and said 'OK, we'll do a refinancing and return some capital to our investors'. And again, for the highest quality assets you can still obtain a good few turns of EBITDA.

Sean: What's interesting about these refinancings – and this is another sign of traditional lenders being quite conservative – is that the banks are not looking at leverage multiples; they're looking at how much cash the equity house will take off the table. And there are certain constraints around. I've seen some where it's limited to 50 percent of your original investment; that's how much they're comfortable with you taking off the table. Whereas if you go back to the heady days of 06/07, you could leverage it up to your eyeballs and get three times your money back. Those days are gone.

You can get a different perspective from some of the alternative lenders, but then you are talking about higher costs, and often a more cumbersome process because you are effectively going through a full refinancing.

Mark: It's always good to get capital back as an investor. However, it has to be looked at on a case-by-case basis. So if the business is cash-generative and able to withstand that

level of refinancing, then: absolutely. If the manager is re-financing the business purely to get money back to investors – when it's perhaps not the right thing for the business – then we'd obviously caution against that.

Sean: I think that the key is that you're doing what's right for that individual investment in terms of its eventual value to the fund – so you don't have the tail wagging the dog, in the sense that you're trying to put too much leverage in the business in order to return capital, just to prove that there's capital coming back.

THE PR BATTLE

Do you think the industry has any kind of image problem in the UK?

Markus: I think the industry has long suffered from being amalgamated into a single word, 'private equity', across a whole range of activities – and therefore you're almost guilty by association. We've seen small venture capital firms, growth capital firms, turnaround funds, special situation funds, midmarket houses, and large buyout funds all put into the same bucket – whereas, in fact, their investment strategies can be – and usually are – very different. Not enough effort has been made to differentiate the various groupings.

I would certainly argue that what we do in the midmarket is very different from what other parts of the market get up to. We are always looking for growth opportunities and organic growth potential. We're trying to make our businesses better; we rarely go into a deal with a mentality focused only on 'How do we improve the cost base here?' Employment growth figures back up that particular story very well – but I can understand that it's not very interesting for journalists to write about that when there are lots of other issues to be written about at the much larger end of the market.

Sean: We invest in private businesses and help them grow, which typically means employing people. So that should be a positive message. But I think sometimes the press doesn't want to hear it, because they're looking for the more challenging stories.

Still, we're trying to promote the growth message. For three years now we've done a UK growth survey where we've gone and talked to two and a half thousand small businesses and asked them what they think about their growth prospects. And actually that's been quite a good news story, because most of them are saying that actually in spite of the economic environment they see good growth prospects and opportunities to create employment. I think that proves to us that in spite of everything, there are actually people out there who are quite positive about the environment.

Mark: I think there is a certain nervousness around the political situation, particularly if you take a pan-European perspective – for example, the situation and sentiment in France is particularly concerning.

But I think there is so much good news about private equity and we need to be a lot better at communicating that – and not just the employment, or the value that's generated within individual businesses. At the end of the day, the ultimate beneficiaries of private equity returns are typically pensioners. And data shows that the returns generated by the best private equity managers – which are obviously who we target – are typically going to be above the listed markets. So yes, private equity executives will be rewarded if they do well – but they will also typically deliver out-performance when compared with the returns investors would receive elsewhere.

The vast majority of private equity professionals are talented and responsible individuals; for every bad news story there are dozens of good news stories that fly beneath the radar. So I think we do need to be far better at promoting the positive message of the value and benefits that private equity can deliver. »

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> Markus Golser

» Whose job is it to get this message out? The BVCA?

Markus: The more diverse your constituency, the harder it is to have a unified PR message. In the UK, that's hard enough I think as the BVCA is trying to answer to far too many different underlying constituent groups. In Europe, it's almost impossible because you've got national pressures that are very diverse and economic contexts that are completely different.

Sean: There was a period where there was a lot of heat on private equity, particularly over tax. That, I think, was handled pretty well and it has largely gone away. I think the current sentiment is fairly neutral. The area that we're all contemplating at the moment is the new regulatory regime that will be foisted upon us and what that is going to mean. And it's not clear to me that our interests have been collectively voiced, because a lot of the regulation would seem to be inappropriate for the sort of businesses that we run. So I think the jury is still out a little on whether that could have been dealt with more appropriately.

Mark: The BVCA is doing a good job in difficult circumstances. But I think in terms of the wider constituency, perhaps individually we can be better at getting some of the good news stories out there, and maybe not rely on the industry body to do that for us.

How do you expect the coming year to pan out?

Markus: On the whole, we expect 2013 to be very much like 2012, and I think that's the conventional wisdom in the market. There's no obvious sign of strong deterioration or improvement – either for the credit markets or the equity markets. In the midmarket, I think there is still an oversupply of capital, relatively speaking, and that will continue to be the case for at least 2013. It may then change if a number of players fail to raise their next fund or withdraw from the market.

Sean: I think 2012 saw a slight improvement over 2011, and we expect more of the same in 2013. The number of opportunities we have seen has been up slightly – and there's nothing to suggest that 2013 will be any different. All of us are doing a relatively small number of deals in a market that has a reasonable amount of volume but is very competitive.

Mark: The benefit that we have now is that we are a year further down the line and so people are beginning to see the lay of the land and gain a sense of perspective.

We also see positive signs that alternatives are becoming more attractive again as investors look for higher risk adjusted returns to match their liabilities. If investors are not getting the yields they want from bonds, and they start to move that money into listed markets, that can have a positive effect too. Rising listed markets mean improved denominator positions for many investors making it more likely that there's capital available to commit to PE. Healthier listed markets may also give cash rich trade buyers the confidence for M&A and if that means GPs can sell more companies and return some capital to LPs, that can only help the situation.

I think that with all down markets, confidence is a huge factor. Sitting here today, of course you are not going to predict anything other than a slow recovery over the next three to five years. But once confidence starts to return, you will get a momentum effect in the recovery – and we are likely to see things improve more rapidly than we otherwise might think today. ■