

Part 1: European Private Equity: A Banner Year for Exits

European private equity firms reported a record exit valuation of 84 billion euros in 2014 from 86 deals, according to a recently released EY study. The twin trends of increased corporate M&A and receptive public markets converged to realize record values for PE investors – a good thing since PE firms have been working off an overhang since the financial crisis. The study said 29 PE-backed firms went public across 10 different stock markets.

EY's decade-long data showed that acquisitions by PE firms at 8x EBITDA or below would result in higher-than-average returns. However, even those that are much more expensive have shown similar returns. That's because at higher valuations, PE firms pick higher-quality, higher-growth businesses that retain their value. Knowledge@Wharton recently spoke with Michael Rogers, EY's global deputy private equity leader, and Stephen M. Sammut, a senior fellow and lecturer at Wharton, to discuss the findings of the report and prospects for the European PE market.

What follows is an edited version of Part 1 of that conversation.

Knowledge@Wharton: To begin, may I ask each of you to very briefly explain how private equity in Europe differs from private equity in the U.S.? What are the headline points of comparison?

Michael Rogers: There are a handful of differences in the operating environment that we see. Europe is a little bit more regulated. They have new regulations, including AIFMD [the Alternative Investment Fund Managers Directive], and some other regulations that have been put in place.

We also see that there are changes in terms of the size of deals. There have been a number of larger deals coming out of Europe in recent years but historically, we've seen strength in the middle market in Europe, and that really came out in 2014 as well. In the U.S., the big have gotten bigger, and in Europe, we've seen the resurgence of the middle market.

I think the secondary buyout market is a little bit different as well. Deals in Europe, they're different than what they've been in the U.S. They've lost some popularity in the secondary market from

LPs [limited partners] pushing back a little bit. But for the most part, the industry is the same, talking about taking good companies and making them better through balance sheet optimization and improved governance. Not a terribly large number of differences, but there are some unique aspects.

Stephen M. Sammut: I see it, by and large, the same way. Just drilling down a little bit into the structure of the funds and the operation of the funds and the way the funds are staffed: While this still very much is a financial enterprise in Europe, the funds oftentimes are populated with people with somewhat more operating experiences than you find in the United States, which gives them a wider breadth of opportunities to look at in terms of basic businesses, and also the kinds of businesses that are available for acquisition.

Mike, you might have to aid me on this — but I suspect there's probably more activity in terms of corporate spin-outs, sources for deal opportunities, than there might be in the United States.

Rogers: Yes. I think the carve-out business is thriving in Europe. Also — just from a structural perspective — we do tend to see a lot of the funds operating out of the U.K., and heading to the Continent from the U.K.

Knowledge@Wharton: Mike, could you take us briefly through the report's key findings?

Rogers: It was a very active year, 2014. I think the main thing we saw was that the stronger European economy really led to a lot of the opportunity to get the exits out the door. So we saw record-breaking exits, but at the same time, PE was really demonstrating a lot of discipline in terms of how they approached the market and what they did.

We've noted on these calls before that the hold periods extended out, and this was a window of opportunity to allow many of those funds to go to the exit markets and be well-received. It was a very competitive year in the marketplace from [the] PE [perspective], and it just happened to be that the right combination of aspects really opened up the opportunity.

There were 29 IPOs on 10 different exchanges in Europe during this period, which was very strong. Then they [portfolio companies] were faced with corporate buyers: competition was up, so many of the sales ended up in the trade market as well. So those exits were up as well, because corporates in Europe had an appetite for many of the entities that PE was selling.

They [Private Equity] certainly created value for their investors during this period, and were able to roll out — almost 16% of the portfolio's entry value was exited in 2014, so you can see how strong it was. This was secondary only to 2006. So we worked through a lot of that overhang that we've talked about in the past. And new investments were up — a major increase in businesses acquired from corporations, from 24 to 44 during that period. So we're seeing that active carve-out space. And there were 49 new purchases from PE, so it was very much an opportunity to take advantage of the markets. It

allowed for the PE funds to release some of that overhang and find a very, very nice pocket of return for their investors.

Knowledge@Wharton: Just so everyone knows, the name of the report is "Forging Ahead: How Do Private Equity Investors Create Value? A Study of 2014 European Exits," and it's available without a fee from the EY website.

I notice from the report that corporate sales were a big part of the picture, but there weren't so many corporate buyers. Steve, you were talking about this in terms of how that's one difference between the U.S. and Europe. Is that what was showing up in the numbers?

Sammut: Well, I think what was showing up in the numbers was that in terms of exit opportunities, that there was perhaps wider international participation, especially from North American corporations seeking to buy European assets from private equity funds.

Knowledge@Wharton: More so than would be typical?

Sammut: Based on the report, the way I read it, yes, more so than would be typical.

That may actually be a long-term trend. It's certainly a signal that the European market has become attractive to North American corporations, for perhaps a variety of reasons. There may be a sense of stability or maturity that's there.

In terms of participation by existing European companies, what I was referring to was that many of them are restructuring, reconfiguring their operations or deciding to divest certain operating units, and these have found their way into the deal flow of the private equity funds operating in Europe. Whenever this happens, it's actually a fairly good sign, because those spin-outs or divestitures basically come with fairly mature, sophisticated management systems in place, operating units in place, manufacturing systems and supply chain management, largely intact.

So the opportunity to build value on that for the private equity funds is very strong.

Knowledge@Wharton: Was the value of the euro a big factor? In other words, were European companies cheap for American companies? Was that perhaps part of it?

Sammut: The report suggests that, and in point of fact, although the euro did not have a dramatic slide relative to previous years, European assets were cheaper from the point of view of the American dollar. So that probably contributed and may have provided, if not an impetus, certainly the bandwidth to pay a little bit more or to bid more competitively.

Knowledge@Wharton: Mike, you referred earlier to the overhang in the market since 2008. ... This has been an ongoing theme for private equity since the financial crash. Have we, in fact, caught up yet in early 2016? Is the market now more in balance, or is it still imbalanced?

Rogers: I think we definitely are. There was a period of time when there was a sense of almost a lack of liquidity in private equity. From our studies, we knew that in many markets, for example, the traditional hold times of three and a half years or so had stretched out to four and a half, even up to as high as five — and in some markets over five — for the average number of years of hold. So that was giving the limited partners a little bit of pause, in terms of concerns about getting one's money back.

People want redemptions at the front, obviously. There are certain timelines that they have. So there was definitely that pull of LPs making noise about the fact that we'd like to get some return on the money. That turned pretty quickly around this time frame. 2014 was really a solid year in terms of the exits, and it moved the LPs from a position where they were short liquidity to being long liquidity.

A lot of money got returned because, obviously, when you sell these businesses, that cash is coming back to the LPs. They took that money

back in. It didn't take them long, honestly, to turn around and say, "Well, what are we going to do with this money? We're still maybe a little bit under-invested in terms of alternatives, so take it back."

So new funds were created and new opportunities to put that money to work were created as well. We've gone back — it's very fickle, right? When you don't think you can get your money back, folks generally want their money back. But the opposite is true too: When they think that there's opportunity for investment, of course they want to be long. So we went through that period.

I think what PE did was, it demonstrated that the opportunity to take the illiquidity risk benefits you, because we didn't have to sell out in weaker periods. We held out until the optimal moment, and then were able to exit, achieve the returns, return your capital, free up liquidity, and now we're ready to go do it again. I think if anything, that may have been a positive for the industry. But at the time, there were folks who were wringing their hands and thinking, "I'd like to see some return of capital here." But that certainly has pivoted back the other way.

Sammut: I agree entirely with what Mike has had to say, and I'd take it one step further to point out that I'm not sure that a capital overhang is as much an issue in any market as it once was. And the reason is we've become much more accustomed to year-to-year volatility, and the expected holding periods now really vary.

There's no predictable 3-to-4-year window. So as a result, many of these investments, which were growth equity investments in addition to being buyouts, basically needed to have that cash in reserve, that dry powder. So what might seem like too large an inventory of callable cash could very quickly reverse itself. I suspect that concern about this particular issue may cool off, at least for this new cycle.

Knowledge@Wharton: Another trend notable in the study was that often, the buyers of the private

equity portfolio companies were other private equity companies. So tell us, Mike, what's behind that? You said they were selling companies, and then they would take the cash and turn around and buy different companies. Is this just a reshuffling? How does that work from a value-creation standpoint?

Rogers: The secondaries have always been more popular in Europe — likely because there's a smaller pool of large high-quality assets than we see in the U.S. So for PE firms, buying assets from other PE firms makes a lot of sense in certain situations. [They are getting] a company that has seen a significant amount of operational improvements — in governance and balance sheet, etc. — which are now ready to be taken to another level.

The new buyers know they've gotten an asset that's had some private equity folks poring over it, but now they can make their own mark on the company in terms of specific operator expertise or value add. Some of the ways that we see that done are clearly on the efficiency side and profit improvement, and on the cost side in terms of taking cost out of your supply chain, and maybe head-count issues or other simplicities that they can run the business through to make it more efficient.

But the new trend these days is trying to find ways to expand the revenue footprint, so I think PE in Europe likes the fact that they buy these entities that have had some professionalization from another private equity fund, and that they can take to the next level, expand the products or the geographies, maybe begin to sell around the world, maybe to devise more of an Internet strategy. That's been a mantra in Europe.

Sammut: There's one thing else to bear in mind as well. We talk about Europe as if it is a country, and although it's far more unified than it was 30 or 40 years ago, it is still a confederation of countries with dramatically different economies and rates of growth and demographics. A portfolio company, once it's reached a level of stability as the result of a first go-around through private equity, may be very well positioned to expand into other European markets which are effectively local, or not as dramatic a move as, say, entering Brazil from the Netherlands.

It's this diversity of the economies of Europe that actually provides a lot of opportunity to make a firm a good investment hypothesis for a secondary buyer. ■