# Part 2: European Private Equity: Market Outlook

*The European private equity market had a banner year of exits in 2014, according to a report by EY released late last year. Michael Rogers, EY's global deputy private equity leader, sees competition heating up and valuations rising in Europe, among other developments. He and Stephen M. Sammut, a senior fellow and lecturer at Wharton, spoke to Knowledge@Wharton about their expectations for the European market amid concerns of the divergence in monetary policy between the U.S. Federal Reserve and the European Central Bank.*

*What follows is an edited version of Part 2 of that conversation. In Part 1, Rogers and Sammut discussed the findings of EY's European report.*

**Knowledge@Wharton**: I know it takes a long time to compile this data and do all the analysis, which is why the report for 2014 was just released this past November. However, based on what you've seen in 2015, how have the trends from 2014 continued or not?

**Michael Rogers**: From what we've seen globally, I think we can expect some level of moderation in 2015. Maybe the term might be "muted" a little bit, although exit activity has remained high. Global PE firms exited companies in deals valued at over $400 billion in 2015 — that's probably enough to qualify as the second-most active year in history. And I think we saw a lot of that continued strength in Europe as well. The trade sales remained strong, and IPOs actually held up, in contrast to the U.S. and Asia, where they fell. Secondary buyers remained active. So we don't have all the stats yet, but I think we can show a pretty solid year, but just a little muted from 2014, which had all the things moving in its favor at the same time. I think if you look back and just think about the year, we started having an oil fall around the world in 2015. It started in 2014, but in 2015, it picked up some steam. The markets peaked in the U.S. in mid- to late May.

We went through the summer OK, and then obviously, got into a rough period. When China rolled out, it had a dramatic effect on the market, causing tremendous volatility and then, essentially, the rest of 2015 was a choppy year. Volatility took over the marketplace, and as we all know, markets don't like volatility, particularly buyers and sellers who struggle to find good, clear price definition in markets where the volatility is as high as it was. So I think we'll see a reasonably strong first half balanced off by a little bit of weakness in the second half. That is my estimate for 2015.

**Stephen M. Sammut**: Well, I think that's as good an analysis as I could give. I'd say one thing, though, that's very interesting about this. Relative to the rest of the world, for the first time in quite a while, Europe looked pretty stable and almost a favorable destination for investment. And to your point that investors do not like volatility and unpredictability, I think that while Europe as a whole might not have been a haven, per se, it was certainly more attractive. And I wonder if that may continue to be the case in 2016.

**Knowledge@Wharton**: That was my next question. What do you see ahead for 2016?

**Sammut**: I think it's going to depend almost more on capital markets globally than activity in Europe. But this year has been initiated with some pretty

remarkable volatility. And I suspect that that's likely to continue.

On the other hand, there are some analysts and pundits — and even [recently], *The Wall Street Journal* — speculating that Europe might actually be insulated from a lot of the turmoil in the global economy. If that is in fact the case, the European funds are probably going to be fairly well positioned, and in fact, investors from outside of Europe, particularly from North America, might actually have some renewed interest.

**Knowledge@Wharton**: Can you tell us two or three things that suggest that Europe could be insulated?

**Sammut**: The diversity within the economy is certainly one factor. The other factor is that Europe is by far a net importer of hydrocarbons, and ultimately stands to be the principal beneficiary of falling prices for oil and gas, perhaps more so than countries that are both producers and consumers.

**Knowledge@Wharton**: Also, even though the euro has recovered a bit, it's still below where it was a couple of years ago. Is that helping with their exports and so forth?

**Sammut**: It helps with the exports but it also makes, at least relative to the dollar, investing in Europe perhaps a little bit more attractive.

**Rogers**: One of the things that we see is that there's certainly ample dry powder. I mean, there's over $140 billion available in Europe right now for assets, and it's becoming very attractive to U.S.-based investors, as we've talked about. But one of the things I would add to Steve's comments — which I think are right on — is the divergence between the Fed and the ECB has created a lot of angst in the world.

In the U.S., they're raising interest rates for the first time in years and putting us on one path. Meanwhile, they're trying to be as accommodative as possible in Europe. If we're global investors — because we know that capital flows around the world and it's available to go wherever it wants — global investors look at that, and see the ECB still in an easing mode and very dovish about interest rate increases. At the same time, you have the Fed coming forward and saying "You know, we're on a path to have maybe as many as four increases in 2016 and leading into 2017." So I think those monetary policy differences are adding to what Steve was commenting about earlier.

**Knowledge@Wharton**: The study talks about increasing competitive pressures for PE firms. There are new funds raised, but not yet invested — the so-called "dry powder." The study says with more money available, one concern is that competition for new investments could push business valuations too high, which puts investment returns at risk. But the EY analysis found no evidence that paying the highest prices for a portfolio company negatively affects returns. What's your take on that, Mike?

**Rogers**: Well, it is an interesting question, because the dry powder continues to build — the number that is in Europe right now available for transactions. And global M&A multiples have averaged about 12x in 2015, for example, one year forward from the study. That's a pretty high level. But what we have seen is some discipline from the funds. A number of them that we talked to around the world said, "Look, we just do not want to get caught out like we did in 2007." And a lot of times, the exits we're talking about that were so successful — for example, in 2014 — many of those were deals that were done at the peak of the market and literally needed that stretched hold period to get the returns they needed. Nobody wants to go through that cycle again, where they buy right at the peak and have to ride down for a long time before they can come back up, and they're so thrilled to have exited in 2014 or 2015 as a result of that. So we hear from them that they really do not want to get out on the curve too high.

One of the things you asked about earlier was M&A in 2015. Corporate M&A was off the charts in 2015 but private equity M&A stayed

roughly flat to a few points up. So I think they were standing back, taking stock and trying to determine exactly where the future is going, and did not have any interest in revisiting the 2007 cycle, when they ended up with some very horrific purchases that were very expensive and didn't work out as well at all.

There were so many bankruptcies, for example, and some very large transactions that didn't work well. But interesting to note, one thing that we took away from the study was — and this is just empirical data — the deals that were done at under 8x EBITDA did tend to show a little bit higher return over time than those above eight.

So to your first question — is that not common sense? I think there is some of that. If it's below eight, they did show a little bit higher returns. But what we did show as well — if they were from 8x to 12x EBITDA, they also did not necessarily show a diminution in return.

What I take away from that is if people pay a higher multiple, they're in competition with others who also view this as a valued asset. They're willing to pay more for it, but the thing that they're going to have to do — and many of them are getting very, very good at this now — is understand that if we as a fund have to pay a higher multiple, we have to have the right value creation plan in place. We have to be able to wriggle out all of the synergies, find those efficiencies in the system, fix the supply chain, enhance the footprint, find a way to grow the business in a very low-growth global environment, and we just have to execute flawlessly against our value creation plan. If we do that, we can still achieve the nice returns that our investors anticipate and desire from our fund without making some of the mistakes we made in the past at market peaks. That's the takeaway.

**Sammut**: Those are sound conclusions, Mike, and it would be hard to refute them. And clearly, if you want to be a participant in this sector, you are ultimately going to have to accept valuations that are higher than might otherwise be desirable. There's always going to be competition for deals, and in times when there are more funds with more capital to deploy, there is going to be an upward pressure.

So what does a fund do? Well, it revises perhaps the investment hypothesis for any given opportunity, and makes a better determination of what needs to be done and how quickly it can be done. This, I think, is also one of the reasons why we have been seeing a shift, particularly in Europe, to having among the general partners — either as consultants or as part of the management teams of the private equity funds — people with operating experiences, because it's very clear that, putting the advantages of leverage aside, the real value creation is going to derive from operations and basically, that becomes more clear the more that you've had to pay. It focuses everyone's attention.

**Knowledge@Wharton**: I know we're talking about Europe, but I do have one last question that I want to ask. It seems pretty clear that the leading candidates in the U.S. now in the Democratic and Republican presidential primaries say they will change some tax policies for private equity, meaning that certain fees will be taxed as income for investors, a higher rate than the way they're currently treated, as capital gains. If that happens, how will that affect the industry?

**Sammut**: Well, first of all, let's be clear on exactly what we're talking about here. This is in reference to the so-called carried interest tax rate.

That is a factor for the general partners who participate in that carried interest and pretty much for them alone, so they may have to make some choices about what they want to do with their lives and careers. Not to sound cynical, but it may be a matter of buying a 40-foot yacht instead of a 60-footer at the end of the day.

But in all seriousness, it'll change the income equation for certain general partners. I don't see how that's immediately relevant, how that would affect the relationship with the limited partners, many of whom might actually welcome

the change. Then again, we heard a lot of this rhetoric in 2012 and I think it isn't so much an issue of who wins the White House, it's basically who's controlling Congress. There are so many priorities, I just don't know that this is going to rise beyond the political rhetoric and into action. I don't know how you see it, Mike, but that's just one citizen's opinion.

**Rogers**: The one thing I get concerned about — stepping back from the policy itself — is does this disincentivize capital formation and investment? If you look at the PE industry right now, we've already talked at length about the competitive nature and how there are more private equity funds today in the world than there were pre-financial crisis.

There's more dry powder; I think we've crossed over and set a record for the amount of dry powder available around the world for investments. We've talked about the competition, and the corporates that are suddenly feeling strength in terms of getting out in the marketplace and doing transactions, so the competitive landscape has gone up incredibly. At the same time, the LPs are getting a little restless, and many of them are looking for reduced fee structures and ways to co-invest and participate, which — when they do that — lowers the returns to the funds. Then on top of that, if we look at this as a potential tax increase at a time when the business is already under a tremendous amount of pressure, that's got to be a concern if you're running one of these funds and you find yourself battling it on all fronts.

I would agree with Steve, though, completely. We have a dialogue around this with our private equity funds at our roundtables and events that we have around the world and in New York. It comes up a lot, and it just seems to be a little bit of a ping pong ball that people kind of hit back and forth when they're looking at potential tax savings. Is it considered a loophole by some? Others would say, "Well, that's the way our business is run, we invest for a living." You know, so that's the way this business is a capital gain. So it may make its way into some rhetoric on Capitol Hill. It's an easy thing to throw out and cite as something that needs to be changed.

But you know, there's not full support from all sides on this, so I think it does become something that rests with the Congress and their ability to take this up as part of a broader tax structure and tax proposal that I think will come after the new president is elected. So we probably don't see much movement on this until after that, at a minimum. ■