

Europe's financial crisis: What does it mean for private equity?

By Veronica Eng (March 2012)

Europe's financial crisis, which rumbles on without the encouragement of imminent resolution, does not initially appear to offer much promise for private equity investors. The current indicators certainly suggest gloom. Activity levels remain subdued, and *pass-the-parcel* secondary deals dominate deal flow. Financial markets are uneasy and credit is in short supply. And a prolonged period of macroeconomic weakness makes for a difficult operating environment.

There is, however, reason for optimism that the period ahead may well turn out to be a generationally-attractive time to have been investing. Firstly, all the drivers of Europe's longstanding outperformance as a private equity market look set to be amplified by the region's ongoing turmoil. The eurozone's structural inefficiencies are as pronounced as ever and will create plenty of opportunity, indeed demand, for private equity's patient and supportive capital. Secondly, the challenging economic conditions are already, and will continue, pressing down on purchase prices.

Historic outperformance and the implications for future opportunity

European buy-out funds have outperformed their US peers by a considerable margin consistently over a period stretching back more than 15 years; top quartile funds, in particular, have delivered a premium of over 400 basis points over that period.¹ The overarching reason for this has simply been the greater complexity and opacity of the market – less efficiency and pricing transparency producing higher returns. Disappointing though it has been for proponents of the European single market, the apogee of which is the troubled Euro itself, the region remains anything but a homogenous economic entity.

Borders, language barriers, diverse regulatory regimes and wildly different business cultures and traditions mean that the corporate landscape is much more fragmented in Europe than in the US. Businesses in Europe, for example, tend to be much smaller, and therefore lack the scale benefits generally available to larger firms. The average enterprise in the US is three times larger than in Europe, according to a study by Oxford Economics. There is also a much higher incidence of family-owned businesses in Europe, with the same study suggesting that some 70 to 80% of all European businesses are subject to some form of family control. These can sometimes be world class businesses, but they are also often subject to forces that compromise their efficiency.

Over the years, this complexity, and the resulting lack of efficiency and transparency, has produced a good supply of investment opportunities for private equity firms. The

¹ Source: Thomson ONE as at June 2011. Data is for all buy-outs (medium to mega cap) in Europe and the US, and showing the top quartile IRR. Since 1997, it includes all funds raised for every vintage year since that date

potential to generate good returns through real business transformation has been considerable. Amongst a range of value creation strategies, the best private equity firms have been able to improve their investees' business processes, expand across borders, and consolidate fragmented markets. And those with well-entrenched local networks have been able to find jewels among the ranks of family-owned businesses. This is often where the desire for a supportive investment partner to capitalise on the international growth opportunity has often been particularly strong. The current turmoil is simply reinforcing all these drivers of outperformance by stalling or even reversing the trend of many years of gentle economic convergence.

Economic slowdown, recession and the implications for the opportunity

The consequences of an economic slowdown simply add another layer of attractiveness to the investment environment. Firstly, weaker conditions generally depress valuations. Indeed, acquisition prices have already come down significantly from their peak of c.10x EBITDA in 2007-08, with the latest S&P LCD Q4 2011 data showing average entry price multiples at 8.8x.² Oxford Economics calculates that cyclically-adjusted price-earnings ratios show European equities are now at their lowest value in 25 years, excluding the low point of 2009. This reflects the longstanding pattern that periods of economic weakness have generally produced private equity's strongest performing vintage years, when capital has been deployed at more attractive valuations.

Secondly, the combination of economic weakness and fragile financing markets has begun to create a demand among many companies for new sources of external financing. Public sector austerity measures and struggling consumers, amongst other factors, are hitting profitability and squeezing internal sources of funding. Meanwhile, corporate bond issuance and bank lending are both now at well below pre-recession levels. The result has been an increase in corporate disposals, either driven by a need to raise capital or to divest of distracting non-core assets. Private equity is well positioned to take advantage of all this. Even more pronounced is likely to be the wave of asset disposals by banks under pressure to rebuild their capital base. The trend has started, but is likely to gather pace in the years ahead, supplying private equity with an especially rich vein of primary deal flow.

Uncertainty and the competitive dynamic

On top of this confluence of positive factors for private equity returns lies the effect of the enduring uncertainty on levels of competition. Nervousness about the prospects for the region, or at least the more exposed corners, has had the effect both of depressing fundraising and flushing out less committed investors. There has been only a very modest improvement in fundraising conditions over the past year, meaning the supply of dry capital is beginning to slip below its long-term average, which Bain estimates to be 2.9 years in the 1999-2010 period. Using the latest estimate of so-called "dry

² Source: LCD Leveraged Loan Review – US/Europe (4Q11)

powder” tracked by Preqin, this would reduce to around 2.5 years’ worth of uninvested capital for 2011.

As for the competitor population, the period immediately following the collapse of Lehman saw the withdrawal of much of the non-typical private equity-style investors such as hedge funds and ultra high net worth individuals. More recently, there has been a gradual withdrawal of some more traditional private equity investors from Europe’s peripheries and the region as a whole. Some of these have been international firms and some have been indigenous groups de-emphasising what they consider to be particularly difficult markets. The result is a more interesting competitive dynamic for the more committed groups than has been the case for many years. The opportunity still requires patience and nerve, but the prize is likely to be very significant.

The ingredients for a generationally-compelling opportunity are all in place: complexity, a scarcity of capital, a supply of high quality assets, and a relatively thin competitive environment. Clearly much depends on the outcome of the Euro crisis, and that remains difficult to predict. But anything short of a completely disorderly breakup of the core of the currency zone still supports the prospects for good private equity returns. Contrary to prejudice, the asset class’ long-term performance suggests it generally does much better when times are tough, than when the leverage flows freely.

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Founded in 1985, Permira is a European private equity firm with global reach operating across 3 continents from 12 offices. Over the past 26 years, the Permira funds (with around €20b of committed capital) raised from pension funds and other institutions have made over 200 private equity investments with a focus on driving transformation to build better businesses.

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