

DEBT'S SHAKY RETURN > THE BRIBERY ACT AND PRIVATE EQUITY

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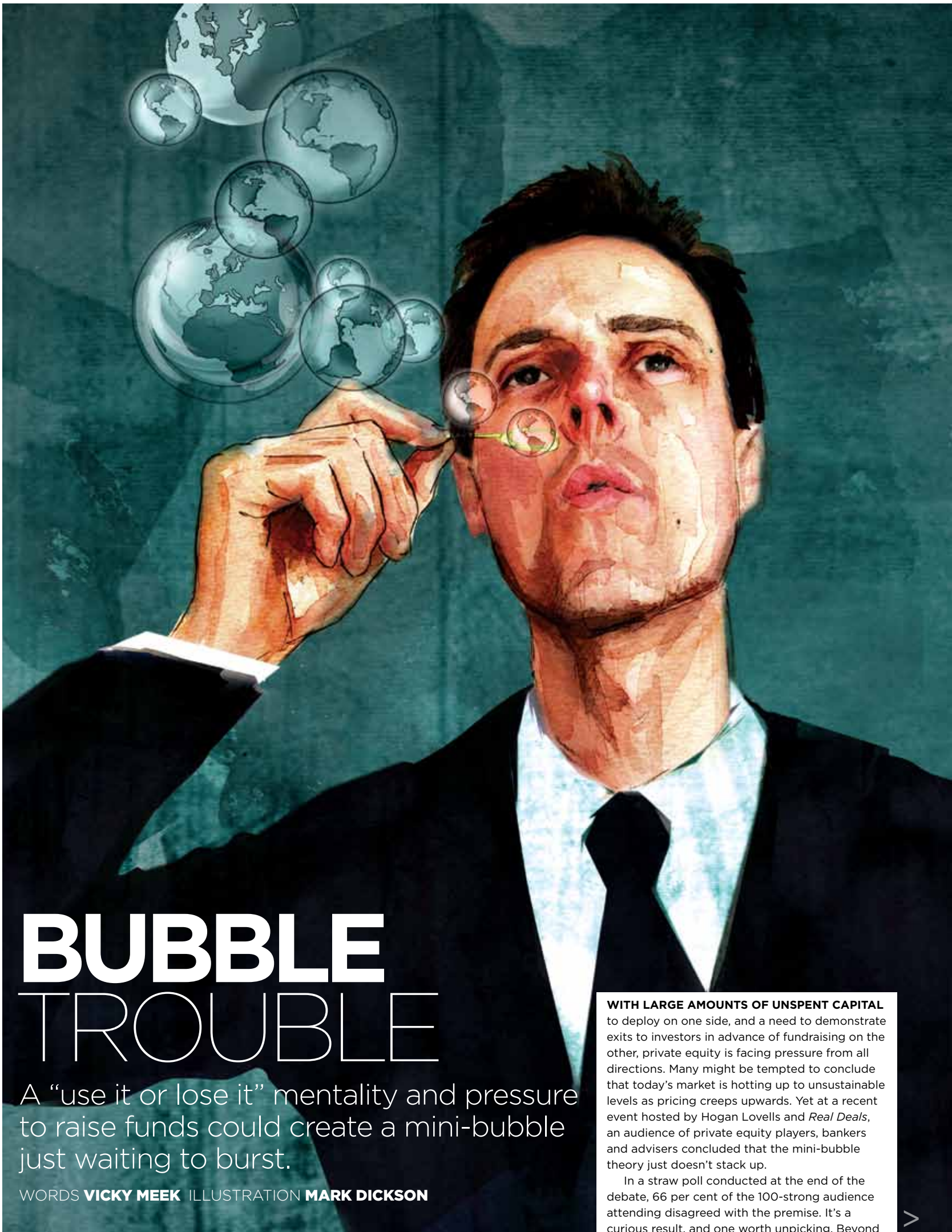


FOREVER BLOWING BUBBLES

Private equity is only just recovering from its latest wave of excess, but a new bubble may already be forming.

FUNDRAISING: INVESTORS CONTINUE TO RESIST EUROPEAN VENTURE'S CHARMS





BUBBLE TROUBLE

A “use it or lose it” mentality and pressure to raise funds could create a mini-bubble just waiting to burst.

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WITH LARGE AMOUNTS OF UNSPENT CAPITAL to deploy on one side, and a need to demonstrate exits to investors in advance of fundraising on the other, private equity is facing pressure from all directions. Many might be tempted to conclude that today’s market is hotting up to unsustainable levels as pricing creeps upwards. Yet at a recent event hosted by Hogan Lovells and *Real Deals*, an audience of private equity players, bankers and advisers concluded that the mini-bubble theory just doesn’t stack up.

In a straw poll conducted at the end of the debate, 66 per cent of the 100-strong audience attending disagreed with the premise. It’s a curious result, and one worth unpicking. Beyond

valuations

the obvious point that turkeys don't vote for Christmas, there are some powerful arguments as to why this isn't happening – for now, at least.

Frightening figures

The figures themselves certainly paint an alarming picture. At the end of 2010, there was \$138bn (€96.8bn) of uninvested capital waiting to be deployed by Europe's buyout funds, according to Preqin (see chart, page 5). This had decreased from the peaks seen in 2007, but was still way higher than historical levels, which have been less than half this amount. On the other side of the fence, Preqin estimates that at the end of 2010 there was \$663bn tied up in unrealised portfolios globally, with 70 per cent of this value tied up in funds with vintages between 2005 and 2007. As a recent Bain & Company report pointed out: "Virtually no buyout fund with a vintage year after 2004 has yet returned paid-in capital to LPs."

There is clearly pressure on both sides, which helps to explain the prevalence of secondary buyouts over the last year. Of the 254 global exits recorded by Preqin for the first quarter of this year, worth \$77.2bn, 65 were secondary buyouts – worth nearly \$11bn.

The debt markets are also helping to fuel secondary buyouts. Banks and other lenders may have greater liquidity than they have had for the last two years, but they are providing credit cautiously and prefer to back businesses that they know already – secondary buyouts often fit their criteria better than new credits. Secondary buyouts also allow them to refinance existing loans on terms that reflect today's higher margins and more rigorous documentation.

For some, this combination is storing up trouble for private equity. "The sponsors' economics means that they have to deploy capital – and that's why we are seeing so many secondary buyouts," says Robin Menzel, partner at Augusta & Co. "For lenders, they get to deleverage and to reprice the credits, and it provides fees for all. Ultimately, it's the limited partners that get hurt."

And there are certainly LPs that are concerned about this "artificial churn". "I've noticed the high level of secondary buyouts for some time now," says Ralph Aerni, chief investment officer at SCM Strategic Capital Management. "Many deals are being kept within the private equity industry. At one point these businesses are going to have to be sold outside the circle."

Yet there can be a sound logic to secondary buyouts, particularly where a company is reaching the point where it needs additional capital from a larger investor. "We've just bought residential care and fostering services business Advanced Childcare from Bowmark Capital," says Mark Tagliaferri, managing director of GI Partners. "The previous owners had built it to a certain level and we believe there is much more scope for growth. Secondary buyouts like these, where a lower mid-market player exits to a larger firm – and we could well exit to a larger house than ours – make sense when seen as a logical progression. LPs tend to be more critical in instances where large firms sell to other large firms without the rationale of the target having greater capital needs."

"From an LP perspective, they care about returns," adds Philipp Schwalber of HgCapital.



“Many deals are being kept within the industry. At one point these are going to have to be sold outside the circle”

“There is very little evidence that secondary buyouts produce worse returns than primaries.”

Painful pricing

So if secondary buyouts are not, on the whole, an issue for the industry, what about the rich pricing we've seen on deals over the last year? In a downturn, you might expect pricing to reduce substantially, but this hasn't been the case this time around. "In the aftermath of the 2008 crisis, there was a lot of talk in the market about fire sales and valuations dropping off significantly," says Annette Wilson, managing director of investor relations and marketing at Palamon Capital Partners. "A lot of distressed funds popped up, hoping to buy assets at 4x to 6x Ebitda. But that didn't happen. Pricing came

down in some areas, but in most it has held up."

Is this the result of the capital overhang?

Some believe it is and that the prices currently being paid will ultimately result in lower returns. "Sponsors have far too much money and are under pressure to deploy it – they either spend it or lose it," says Menzel. "The value of companies has therefore held up and that's why we've only seen a de minimis decline in the multiples paid since the downturn. Average Ebitda multiples for LBOs peaked at 9.7x in 2008, came down to 8.9x, but now they are back up at 9.2x, even though the world is now more risky. There is less debt leverage available and that at higher cost."

"Prices are high, even though business plans are more conservative than they were before the crisis," Dominique Gaillard, managing director of

direct funds at Axa Private Equity, recently told *Real Deals*. "The issue is that people's return expectations have lowered and so, while they might have targeted 25 per cent-plus before the crisis, they now seem content with 15 to 18 per cent and so can justify paying the prices. We'll see in five years' time whether they were right in settling for this."

However, many in the market would counter that a lack of reduction in valuations has more to do with the kind of business that has been appearing on the market lately than a feeling of panic among GPs desperate to put money to work. "The prices being paid remain sensible," says Simon Tilley, managing director at DC Advisory Partners. "The businesses that changed hands in 2010 were great businesses - that's why they were fetching great prices. The not-so-great businesses were either not brought to market or, if they were, they didn't get sold or didn't fetch great prices."

"Pricing has gone up," says Wilson. "But this tends to be for strong companies that have weathered the storm well. Vendors are not being forced to sell - they have good businesses. That means you have to pay reasonable multiples of, say, between 8x and 12x Ebitda to complete on a deal."

However, Wilson adds that some of the higher prices being mooted tend not to get past the first post. "On the exit side, when we've run processes, we've found pricing is very wide at the initial stages," she says. "You find that some bidders low-ball, going in at a low price, while others over-egg the price to get into the process. Yet ultimately, we've found it's the bidders that go in at a reasonable level that tend to complete on deals - the lower and higher bids drop out. The normal price range does tend to be in the 8x to 12x Ebitda multiple."

Of course, there is variation in pricing by sector, with retail - perhaps counter-intuitively in a downturn - along with more defensive sectors such as healthcare seeing some of the highest valuations. Many would argue that this simply reflects these sectors' growth prospects and the quality of the businesses being sold. "In healthcare, the lower-quality assets haven't traded at all," says Schwalber. "When you have decent assets and reasonable leverage, prices will rise, but that's not because there is a horde of stupid investors out there."

"There are a lot of healthcare opportunities that people haven't yet spotted," says Holger Kleingarn, partner at Palamon Capital Partners. "And in retail, the theme around online spending is a hot one as there is a lot of scope for growth. In continental Europe, with the exception perhaps of Spain, the consumer markets have not moved that much so there is still a lot of demand in retail and channels are expanding - that's why pricing is where it is."

Trade's mark

Adding to the pressure on pricing is the return of trade buyers. There is estimated to be around \$2trn sitting on European and US corporates' balance sheets currently - capital that many are predicting will be spent on acquisitions as companies move from survival to expansion mode in an improved economy. Not only do they have funding, but these buyers have a better chance of outbidding private equity than they have had

AUCTIONS - THE SAME, BUT DIFFERENT?

As the M&A market has started picking up - and sponsors have felt the pressure to exit investments ahead of fundraising and to provide distributions for LPs - so auction processes have started gathering pace.

Are we seeing a return to the kinds of wide processes that were run in the boom times?

Not quite. Many firms have said they won't participate in wide auctions and are attempting to source deals off-market. "There are good investments out there," says Mark Tagliaferri, managing director of GI Partners. "Auctions can provide good deals, but we prefer not to go to these. The deals may not be cheaper off-market, but you can at least get closer to management that way."

This has meant that advisers have had to adapt to the environment. "The auction process has evolved," says Eric Bismuth, chief executive of Montefiore Investments. "Before the crisis, memoranda were sent out to everyone, but post-crisis, funds have avoided large processes. Instead, what we're seeing is a process that is made to appear like a one-to-one discussion, although this is actually

happening with around five funds in parallel, and everyone pretends that it is a one-to-one discussion. Then it ends much more like a traditional process. It's a pretence, but it has created a situation where firms can get to know management better than previously."

It has also meant that firms have had to adapt, ensuring that they have enough people looking at the right deals, particularly above the lower-mid-market end. "Origination is tricky at the moment for many funds," explains Bismuth. "If you're fishing in the €150m-plus market, the share of secondary buyouts is high and around 90 per cent of deals are intermediated. The challenge for these firms is to ensure that they have adequate resource allocated to the deals they really want rather than spreading themselves too thinly. Otherwise, the risk is that they lose all deals or they get the pricing wrong. Below €150m, this is less of an issue because deals are far less intermediated and here firms simply need to continue sourcing deals off the market. A lot of that comes down to knowing sectors very well and having a brand on the market."

for some time, largely because it is taking private equity longer to get comfortable with businesses and to secure debt for acquisition.

"Trade buyers have always been there," says Tom Whelan, private equity partner in the corporate group at Hogan Lovells. "But they are able to operate on a more level playing field now. Although the debt markets are returning, buyout houses need longer to arrange finance and increased regulation of private equity will mean corporates are in a better position to compete." Indeed, CVC Capital Partners is believed to have been outbid by Liberty Global when EQT Partners recently put German cable network provider Kabel BW up for sale.

The fact that private equity is being outbid

for assets could be held up as an illustration of the moderation in buyout houses' behaviour when it comes to acquisitions. "There has been a lot more competition for assets over the last year as corporates have returned to the market," says Wilson. "Most of our exits have been to trade."

And, while the end of last year saw an upturn in deals being completed by private equity, the first quarter of 2011 saw a drop. In Europe, the value of buyouts fell from nearly \$20bn in the last quarter of 2010 to \$17bn in Q1 this year, according to Preqin figures. If there is a mini-bubble to emerge, there appears to be no evidence to support that it has happened yet.

"There is pressure to get investments out of the door," says Whelan. "Funds have to justify

PLENTY IN RESERVE - DRY POWDER, 2003 TO 2010

