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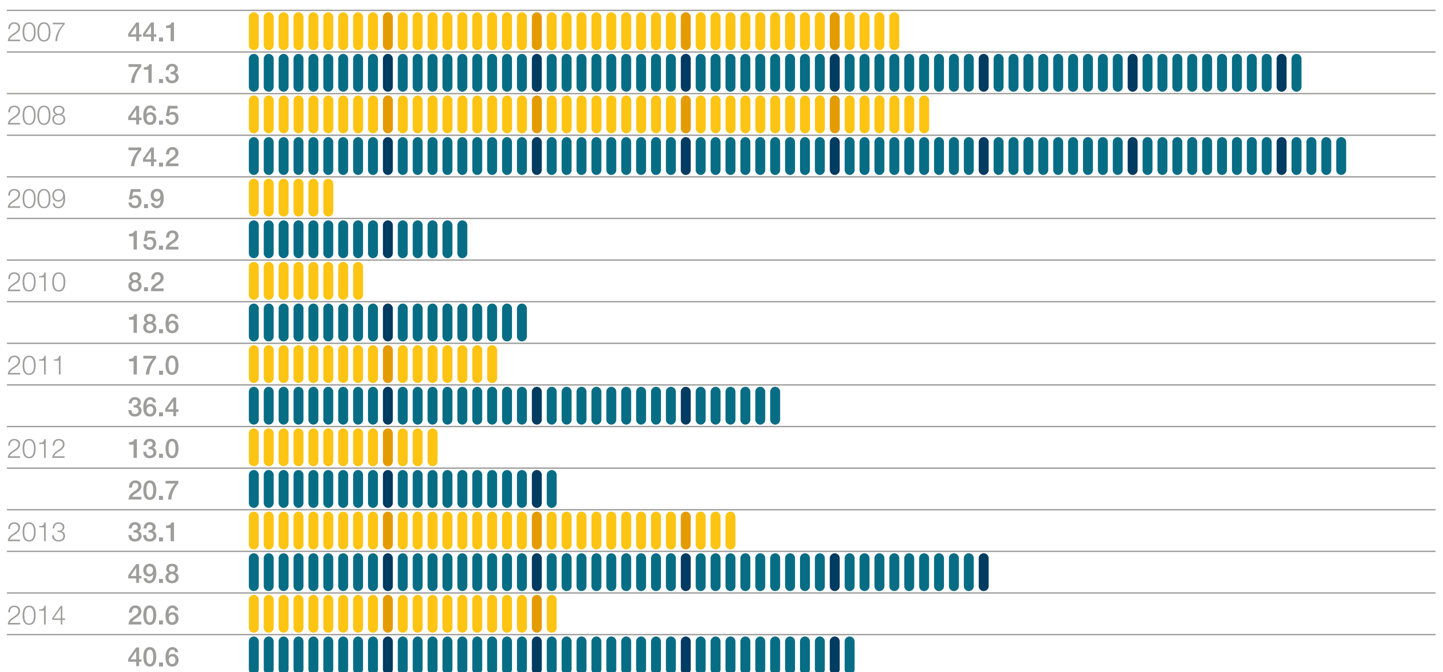
The Private Equity Conundrum

Incremental funds raised per year, excluding venture, €bn



● UK ● Europe

Source: EVCA Yearbook 2015.

The UK market – where are we right now?

Private equity (PE) has its challenges. Investments are illiquid. No matter what your investment record looks like the pressure is on with every new fund and investment. Pressure from stakeholders to realise investments and unfavourable market situations can lead general partners (GPs) to sell a very good company below its true value. Conversely, the rush to allocate available capital can lead GPs to overpay at investment.

After hitting a nadir in 2009, the industry has been increasingly bullish of late. Market participants have been buoyed by low interest rates and the improved prospects this has brought for assets in the market. However, this bullishness may be misplaced. The European economy has been slow to react to low interest rates and inflation and is vulnerable to the effects of another global crisis.

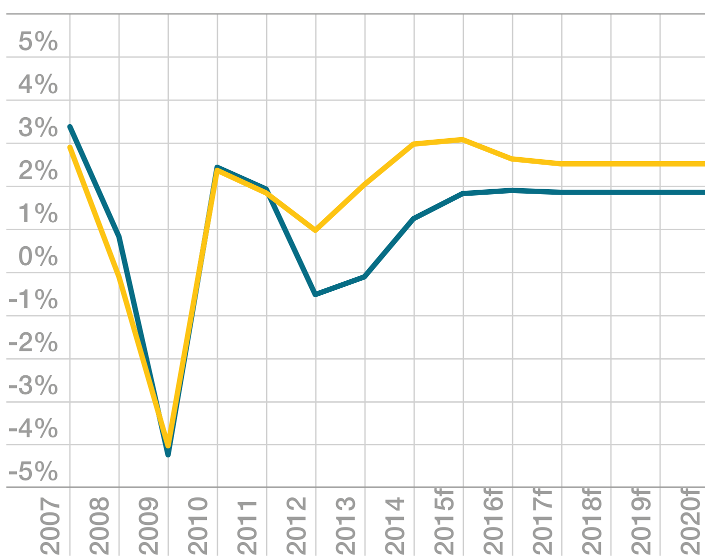
While mainland Europe has seen mild to stagnant growth and is not expected to accelerate in the near future, the UK market has recovered better than most. However, Britain still faces the same challenging economic conditions as productivity has not grown in line with the economic stimulus.

This macroeconomic situation has had a unique impact on equity investments as low interest rates have pushed investors out of bonds and into equities and alternatives. The poor macroeconomic outlook has failed to provide a rational backing for the six year bull market – recent corrections notwithstanding – seen in those asset classes, private equity included.

This macroeconomic situation has had a pronounced effect on PE practitioners. Faced with record low interest rates, GPs have jumped to the same, entirely sensible conclusion – “investors want to stay away from bonds, therefore now is the time to fundraise.” And fundraise they have.

According to the European Venture Capital Association (EVCA), fundraising since 2012 has stepped up in Europe and the UK to levels not seen since 2008. However, while European GPs seem to be putting these extra funds to use, the UK market is registering record levels of dry powder due to a lower number of investments and a higher number of divestments than pre-crisis.

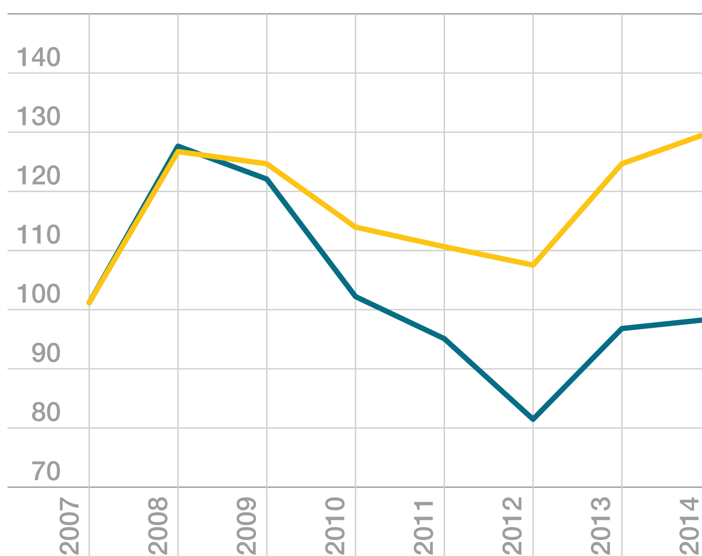
Real GDP evolution



● UK ● Euro Area

Source: IMF World Economic Outlook database, April 2015. Forecasts by the IMF, at April 2015.

Indexed evolution of dry powder, 2007=100



● UK ● Euro Area

Source: EVCA, CIL.

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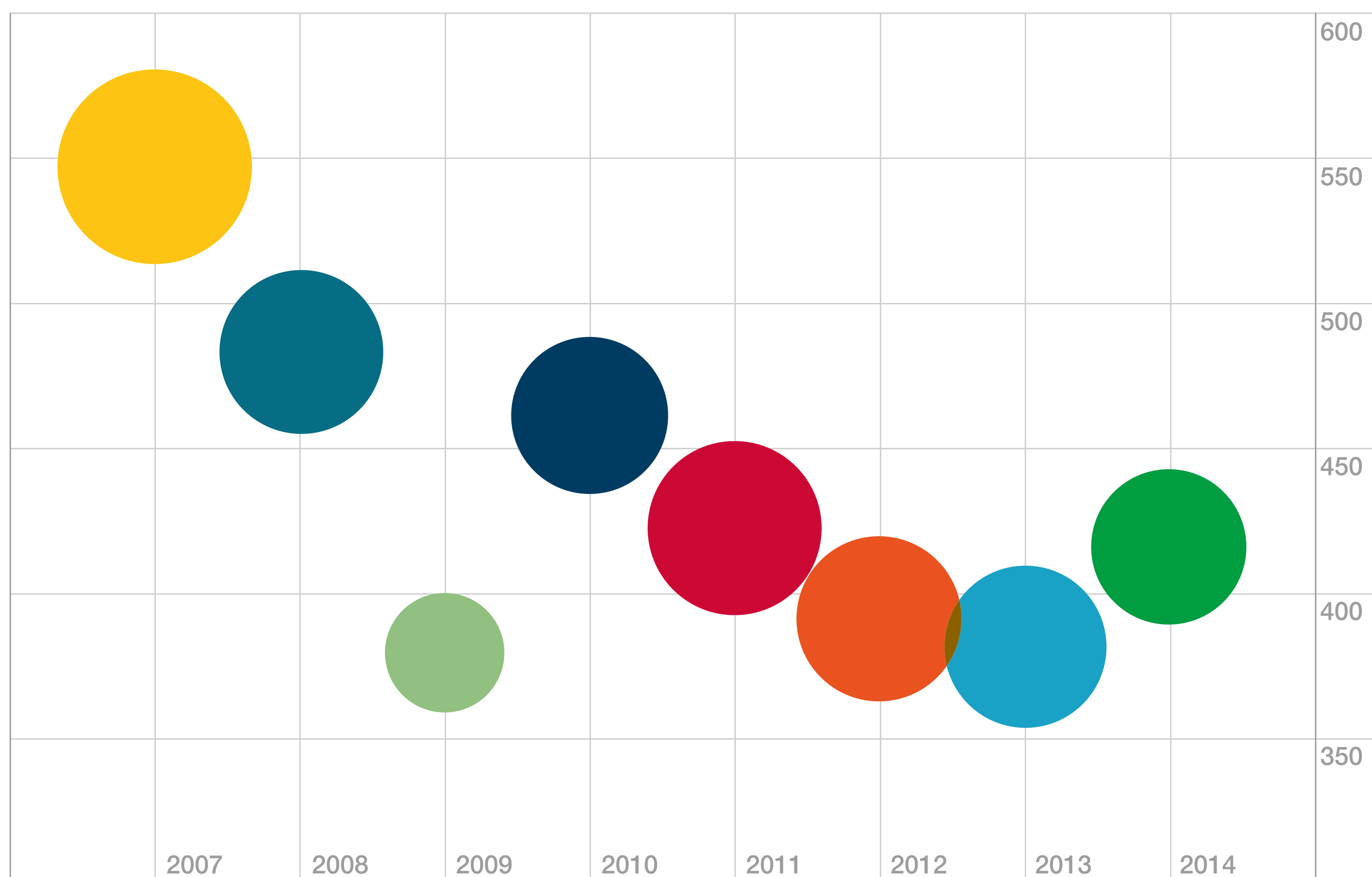
Why is this happening?

Evolution of number of PE deals and average deal size in the UK



Source: EVCA, CIL. **Note:** bubble size indicates average deal size for the year; excludes venture capital.

High levels of fundraising and dry powder have increased the pressure on GPs to invest. However, this pressure comes at a time when not many deals are available. 2014 is seen to have exhibited the highest level of PE activity since the financial crisis, but dealflows are still 25% lower than pre-crisis highs.

There is more money chasing fewer deals. While in 2008 there might have been one or two different GPs looking at a potential target, in 2014 an increasing number of firms are involved in competitive auctions (CIL has seen as many as six different PEs involved in "stage two" due diligence). As a result, many GPs have seen an increasing number of unsuccessful bids and therefore failed to complete as many deals as expected.

The explanation for this peculiar environment is two-fold. On the supply side, the levels of capital raised over the last two years has led to increased pressure for capital deployment. This, in turn, has driven pricing multiples to levels at which GPs baulk. M&A activity outside private equity markets is also in rude health, driving up asset prices. Cash reserves built up by corporate players since the crisis are now being put to use in search of increased growth.

Low interest rates also mean that potential targets have access to larger pools of cash, diminishing their need to seek alternative funding sources. Put simply, some CEOs and business owners think, "Why participate in a buyout when the bank is offering cheap money?"

This trend has been counterbalanced by the high prices seen in the market, which has encouraged some companies to transact now rather than later – especially the ones already in the hands of PE funds.

When combined, these factors have created a sellers' market where good assets transact at challenging multiples (when compared with historic prices, and even though the average asset size has been lower than in past years). Given the level of dry powder in the UK, this situation is not expected to change unless fundamental shifts occur in fundraising or investment activity (e.g. an increase in interest rates).

How should Private Equity funds react to the market context?

CIL expects GPs to try and stabilise current dry powder levels, at the very least, and an argument could be made for more aggressive investment by GPs. We have modelled three scenarios to evaluate the impact that different levels of dry powder deployment would have on UK dealflows between 2015 and 2020 (all scenarios assume average fundraising levels will be equal to the last three years up to 2020).

The graphics below show the average number of deals expected in the market for each of the next six years under these three scenarios, assuming an average deal size equal to the one experienced in 2014.

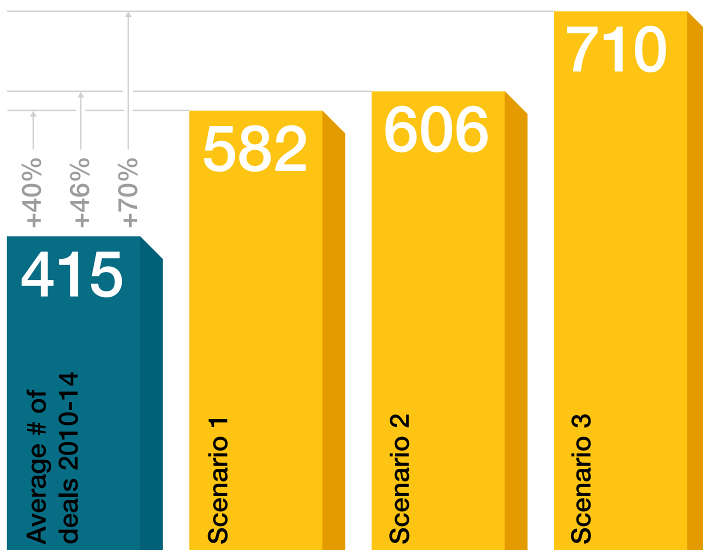
Given these scenarios, it seems clear that UK GPs will need to either find more deals, pay more for the deals available or be more creative. These options are inherently limited by the number of deals available in the market; the size of those deals; and the ability to find non-obvious investment opportunities.

In scenario 1, we assume that levels of dry powder will stabilise at 2014 levels, and any further fundraisings and divestments would reach parity with new investments.

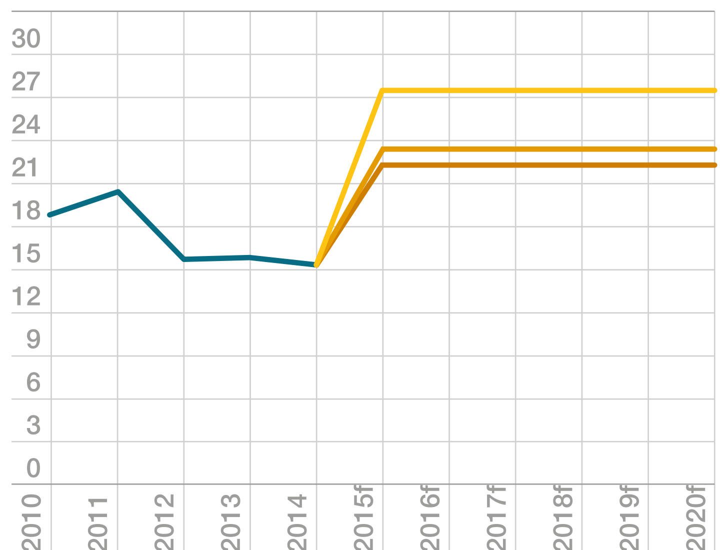
In scenario 2, we assume a small reduction of dry powder, to 2013 levels. This scenario implies investments would slightly outweigh fundraising plus divestments.

In scenario 3, we run a stress test on the market and assume that dry powder levels would revert to 2007 levels in the UK – in line with current European levels.

Average # of deals by UK GPs per year, historic and expected under each scenario



Likely evolution of investment levels in each scenario, £bn



Historic · Scenario 1 · Scenario 2 · Scenario 3

Source: EVCA, CIL.

These factors have created a sellers' market where good assets transact at challenging multiples…

What can general partners do?

In our view, PE teams should explore the following strategies:

Expand overseas – increasing the level of investment outside the UK is often difficult due to restrictive investment mandates and the lack of international capabilities of some market players. CIL believes there is a good opportunity to replicate successful UK business models in mainland Europe and emerging economies, as well as for the expansion of buy & build propositions from the UK into those geographies (using the UK entity as a buying platform). This is a model that has already been successfully explored in the past in the upper mid-market by some European GPs (e.g. Labco, Trescal).

Increase co-investment – although not solving the issue for the industry as a whole, the increase of co-investment should allow individual GPs to deploy capital in attractive (typically higher value) assets, easing the pressure for deployment of idle cash. Furthermore, co-investment allows GPs to participate in deals beyond their mandate and to explore opportunities that would otherwise be closed to them.

Improve deal-sourcing capabilities – the number of GPs with deal sourcing teams is limited. Most players in the market still rely on warm introductions and contacts in their industries of expertise. GPs who have developed these teams in the past have typically generated greater returns and, as the market becomes increasingly competitive, more GPs are expected to further develop in-house origination and genuine sector focus.

Locate opportunities for market consolidation – GPs should capitalise on mispriced assets. When merged together, the combined value of several small companies is typically greater than the sum of the constituent parts, due to the creation of a more powerful market position. UK GPs have successfully done this in the past and pursuing this strategy in the future – both domestically and abroad – can still yield very good results.

Locate arbitrage opportunities – given the opaque nature of private markets, arbitrage opportunities in pricing often exist. This is often because a certain sector is undervalued or because the asset is owned by a non-educated investor (a recent Financial Times article showcased this by comparing HBO and Netflix valuations, arguing that HBO is potentially undervalued given both companies are pursuing the same strategy). Pure arbitrage is hard to find, but GPs who are able to do it and hold an asset through market turmoil can profit handsomely.

Expand non-traditional options – over the past three years, CIL has seen an increased number of non-traditional deals, where GPs act in a manner closer to a venture capital fund. Some funds are now backing management teams with little or no assets due to the perceived potential of a market. As dry powder is put to use, we would expect this trend to continue. For example, a fund might support a buy & build opportunity from scratch, rather than launching from a platform already operating in the market.

The most successful investments that CIL has seen in the past five years have employed one or more of the strategies described above. The question for GPs now is to prove that those successes were not one-off occasions, but signs of a maturing asset class and of true competitive advantage over their peers.

Author: Pedro Caseiro – September 2015

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