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Europe's competitive edge

*Sustainability could prove a critical differentiator for a
low-growth continent, write Carmela Mendoza and Amy Carroll*

The pace of European private equity dealmaking remains frenetic, despite a stubbornly persistent global pandemic. Indeed, instead of the typical two annual M&A peaks in a year, there have been four in the past 12 months, according to Travers Smith partner James Renahan.

“As a result, the advisory community is now close to capacity, or else exhausted. For example, getting hold of teams to conduct commercial or financial due diligence is difficult unless you are a big fund able to pay premium fees. Similarly, a number of underwriters in the warranty and indemnity insurance market have seemingly closed their books for the year,” Renahan explains at *Private Equity International's* European mid-market roundtable, hosted virtually in November.

“Bigger deals may continue to get done because of the fees on offer, but I suspect deals in the traditional

mid-market are likely to stutter as we run into the end of 2021.”

Rupert Howard, director and co-head of UK private equity at 3i, agrees. “Advisers across the board are stretched with both buy-side work and preparing the next cohort of businesses for sale. I think everyone has been taken by surprise as to how sustained this M&A boom has been.”

Mark Zünd, partner and head of private equity investment at Unigestion, adds that, short of a market correction, the volume and velocity of deal activity is likely to continue.

“So far, the majority of deals that have been taking place have been in a relatively limited number of sectors,” he says. “There are still a lot of companies out there that need to be exited, in sectors that have been more impacted by covid.”

The sheer volume of deals is forcing buyers to triage their pipelines and make early calls. “Our focus remains on getting to know businesses in advance

of processes. But, in this market, we have to be tougher on which to progress,” says Howard. “Sometimes that may mean missing out. At the same time, there is so much money chasing scarce assets that they all seem to find a home.”

Renahan, meanwhile, says the nature of legal negotiations seems to have shifted. “The focus of our work as lawyers at the moment seems to be more on facilitating smooth and speedy transactions rather than minimising the negotiation of contract terms,” he says.

“In particular, we have seen the widespread use of warranty and indemnity insurance increase in support of transactions with £1 liability caps. Sales processes have primarily become largely about getting the insurance to a certain point, rather than negotiating risk sharing between buyer and seller, as it used to be.”

At the same time, the trend has moved from auctions towards bilateral

**Mattias de Beau**

Partner, primary investments,
Adams Street Partners

Mattias de Beau focuses on Adams Street's European primary portfolio and is involved in the sourcing, screening, execution, monitoring and exiting of growth and buyout co-investments. Prior to joining Adams Street, he was a managing director at StepStone Group, a principal in the private equity secondaries group at Greenpark Capital and a private equity analyst at Lehman Brothers.

**Richard Dammig**

Co-head of private equity investments,
Europe, Schroders Capital

Richard Dammig co-heads Schroders Capital's investment activity for its European investment practice. Before joining the firm in 2011, Dammig worked at CapVent, and, from 2006 to 2009, was an associate in the corporate finance team at PricewaterhouseCoopers in Zurich. He was also a controller and corporate M&A analyst for ABB.

Rupert Howard

Director, 3i

Rupert Howard co-heads UK private equity at 3i and leads the firm's consumer team. He joined 3i from Rothschild & Co, where he was a director in the consumer, retail and leisure division. He brings 12 years' experience advising both public and private companies on transactions across the UK and Europe.

**James Renahan**

Partner, Travers Smith

James Renahan is a partner in the private equity and financial sponsors group at Travers Smith. He acts for both institutional clients and management teams, advising on domestic and international transactions. Renahan joined Travers Smith as a trainee in 2000 and also spent a year on secondment with Equistone before becoming a partner in 2011.

**Mark Zünd**

Partner and head of private equity investment,
Unigestion

Mark Zünd is head of Unigestion's private equity investment unit and a member of the firm's private equity investment committee. Zünd was previously a consultant at McKinsey & Co, where he focused on post-merger management, supply chain optimisation and business development. He then joined a European e-commerce application service provider before moving to Lombard Odier Private Equity, which later became Unigestion.

transactions – and informal processes with a small group of interested parties – through the pandemic. “It will be interesting to see how that plays out,” Renahan adds.

Relative value

Valuations have also continued their ever-upward climb over the course of the past year. But are those valuations always warranted? Clearly, companies that have experienced a covid boom – and particularly those with digital-first business models – are commanding high prices.

“Tech and healthcare companies generally held up particularly well through the pandemic, and in some cases saw an acceleration in performance and earnings,” says Mattias de Beau, partner at Adams Street Partners.

But lower-quality assets are also trying their luck. “Just because a great business is being valued highly doesn’t mean an inferior business can also command four times more than it did a year ago,” says Howard. “That is giving rise to some tricky conversations with advisers.”

“In some cases, increases in valuation will be justified. In other cases, they won’t,” adds de Beau. “Valuations seem to have increased for all businesses in those sectors that have remained active, which means rigorous due diligence is more important than ever.”

Richard Damming, co-head of private equity investments, Europe, at Schroders Capital, however, says there is a bifurcation in valuations between the lower mid-market, the upper mid-market and the large buyouts segment. “That chasm is wider than ever, which means we are seeing multiple expansion on exit like we have never seen before,” Damming says. “To me, that shows that the highest asset inflation is occurring where there is the highest concentration of capital. That also means those parts of the market are the most exposed to a correction in valuations.”

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RICHARD DAMMING
Schroders Capital

Big buyouts are also closely correlated to the public markets, Damming explains. “That’s partly because IPOs are a common exit route. It is also because the bonds often used to finance these acquisitions are closely linked to the fixed income market. As soon as interest rates move, the leverage available for those big transactions will come down.”

Damming believes value contraction risk lies in the pre-IPO growth market, as well.

“That segment is highly correlated to public markets because investors participating in those late-stage financing rounds expect to see a nice bump when the company lists,” he says. “Once that uplift fades, you will see capital retreating from that space. Those are the two areas where we see the biggest risk of contraction. At the moment, things are only going in one direction, but you never know what will trigger a change.”

The weight of capital in the market looking for a home is inevitably one of the most significant factors impacting valuations. And, increasingly, this capital is not only stemming from home-grown European private equity funds. De Beau points to growing interest from US VCs in Europe’s flourishing venture industry as an example.

“The European VC market has witnessed a huge resurgence in recent years, with strong growth in the number of high-profile outcomes,” de Beau says. “That has led to an increased number of repeat entrepreneurs, which has really started to feed the flywheel in terms of Europe’s venture capital universe.”

Asian and US firms move in

Indeed, a recent Adams Street white paper revealed that Europe’s share of global venture investment has almost doubled in the last five years, now accounting for over 18 percent. In 2020,

The next generation of European superstars

Our roundtable participants discuss where to get the best returns

Track record is imperative when it comes to identifying future private equity success stories, says Mark Zünd of Unigestion. “We require experience in an institutional private equity setting. The strategy also has to be scalable,” Zünd says. “That is the only way the firm will be able to afford the necessary infrastructure to thrive.”

Richard Damming of Schroders Capital says his firm favours sector-specialist emerging managers and firms operating on a pan-European – or at least regional – basis. “That is where we believe the best returns can be found today,” Damming says. “Europe remains far more fragmented than the US, so a firm with both sector expertise and M&A experience has the opportunity to consolidate industries and create European champions.”

Sector specialisation is also an important theme for Adams Street Partners, which tends to identify emerging managers within its existing network. “It may be an individual spinning out from a manager we have backed in the past, for example, so we know that individual and their track record well,” says the firm’s Mattias de Beau. “We have seen a number of spin-outs in the tech and software space over the past couple of years, but still relatively few in healthcare, where I think there is a real opportunity.”

Spin-outs are also an important source of emerging managers for Unigestion, which particularly welcomes

the opportunity to partner with firms that have been created in non-acrimonious circumstances.

“Spin-out situations are typically a consequence of poorly managed generational transitions or an unwillingness to share economics,” says Zünd. “But we do also see some friendly spin-offs, where someone leaves on good terms and the old firm may even back their former colleague. It doesn’t happen often, but we like those dynamics because the spin-out retains access to the network they have built up. Their ecosystem remains intact.”

Damming adds that access to a pipeline of deals can be another positive when reviewing a potential new relationship, but says that it is important to due diligence how tangible that pipeline actually is.

“We typically ask to be involved in the due diligence process for one of the firm’s early deals,” he says. “That helps you see how the strategy is being implemented, and really is the best way to learn about a team. In some cases, we gain added comfort through that process, but in others we observe things that make us glad that we still have a way out. We have seen situations, for example, where there are arguments between people from day one. You know then that that is not going to be a successful or longstanding firm.”

European start-ups raised over \$46 billion in funding. That is more than double the \$19 billion total for 2016, and more than 10 times the \$4 billion raised in 2010.

“Part of that increase in funding has come from established US firms that now have boots on the ground in Europe,” says de Beau, who adds that although international competition has been less pronounced in the buyout space, there have been instances where Asian buyout funds have acquired Europe-based global brands or brands where there is opportunity to expand into the Asia market.

Zünd, meanwhile, says the biggest shift in competitive dynamics that he has noted involves the entrance of

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RUPERT HOWARD
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non-traditional buyers, such as hedge funds and institutional investors, investing off their balance sheets. “It will be interesting to see whether those investors have the necessary infrastructure to support these businesses over the long term,” he says.

De Beau agrees: “Hedge funds tend

to only compete on price. One of the risks, then, for these new entrants, is that they will end up buying the assets that private equity firms don’t want.”

“We are definitely hearing about a few hedge funds dipping their toes in the water,” adds Howard.

“But private equity investing isn’t

only about transacting. It is also about value creation. A management team generally wants a partner that can help them deliver on strategy.”

Technology vs human capital

In a high-price environment, value creation is more important than ever. And, of course, tech-enabled transformations are often deemed most critical of all. “We have a digital director that sits across the entire portfolio. We are not fans of the operating partner model, but digital and technology play such an important role across so many industries that it is important to have that talent in-house,” says Howard.

Damming, meanwhile, says Schroders Capital’s private equity portfolio contains businesses that provide consulting services to companies, helping them to digitise. “These companies have experienced an incredible boost as a result of covid – doubling or even tripling EBITDA in a single year,” he says. “That just goes to show that a lot of companies are behind where they need to be when it comes to a digital presence.”

Damming says this is particularly true of the consumer space. “Nowadays, younger generations engage through social media, for example. That is key to

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being a successful consumer business. But covid has proved that digital is critical for other industries too. Take clinical trials: companies used to interview people on premises at the start of a new trial, as well as on an ongoing basis, and collected data along the way. During the covid lockdowns, new technologies were used to interview trial participants and capture data.”

Despite the supremacy of digital technology in today’s world, however, private equity remains resolutely a people business. “The number one priority for us is looking after talent,” says Renahan. “A lot of law firms are losing people to burnout or to the ‘you only live once’ syndrome. Lockdown and relentless deal volumes have undermined resilience and, as a result, support and culture have never been more important. The minute you view your people as a commodity, you are in trouble.”

Howard agrees that the importance of human capital is paramount. “We have embraced flexible working,” he

says, “because recruitment and retention is about more than just a payday, and rightly includes your approach to ESG, DE&I, your work culture and your work environment.”

Why Europe?

Indeed, ESG could prove to be a critical differentiator for the European private equity market on a global stage.

“The US is currently the largest market in the world. It is professional and liquid with the most advanced technology and healthcare industries anywhere. It is clear, then, what investors get from investing in that region,” says Zünd. “Asia, meanwhile, is high growth and innovative and will be the largest economy going forward. But low-growth Europe has to figure out why investors should allocate capital to that market. The answer could lie, in part, with ESG and sustainability.”

Renahan adds: “We can see from the COP26 negotiations that there is considerable pressure on China and

the US, as well as the corporates and financiers in major global economies. That provides a real opportunity for investment in Europe, which has been ahead of some in its thinking. We have great technology and smart people in this area and there is an opportunity for the continent, including the UK, to be at the front of the fight against climate change, which will be good for those looking to invest in Europe in the coming years.”

Damming believes European private equity will continue to flourish, despite a low-growth macro environment. “European private equity has always delivered top-notch returns regardless,” he says. “Private equity looks towards future-proofed businesses and helps those businesses become bigger, stronger and more resilient, even when there are headwinds. When an Asian or US investor asks me why they should allocate to a low-growth region, I tell them that low growth is irrelevant. European private equity always delivers.” ■