European Private Equity Thrives With Record Fundraising

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Private equity (PE) fundraising in Europe hit €91.9 billion in 2017, the highest it has been since 2006.[1] Of that amount, €71.7 billion was invested in European companies, an increase of 29 percent year over year. This record fundraising in the highly competitive European PE market has led to a number of trends, including a continued rise in the levels of dry powder, the increasing prevalence of co-investments and a greater appetite for minority investments.

Dry Powder

The levels of dry powder — uncalled capital from investors ready to be deployed — in the PE industry hit new heights in 2018, continuing the year-over-year increases since 2012. As of June 2018, PE fund managers had on hand €125 billion in Europe and $1.07 trillion globally. One cause of these levels of dry powder is the success of PE firms in fundraising, in part driven by a relatively unchanged macroeconomic environment, with continuing low interest rates and PE's prospects of higher returns than in public equities. Another reason for the high levels of dry powder is the difficulty PE fund managers are encountering in actually putting the capital raised to work, given the current seller-friendly environment.

More money in the market and a limited number of attractive assets — typically those with predictable recurring cash flows across the economic cycle that are able to support leveraged financing — mean that the competition for those assets is fierce. This not only leads to worries over inflated asset prices but also affects the acquisition process. In order to win the most attractive assets, the ability of PE firms to transact within a small number of days, on a diligence-lite basis and typically with legal terms that are highly favorable to the seller (*e.g.*, limited post-completion recourse for the buyer and fewer earnout/deferred consideration structures), have become increasingly important. As a result, with PE funds being given more money to invest but finding it harder and harder to do so, it is unsurprising that we are seeing such high levels of dry powder. The need to put capital to work and provide returns in such a competitive environment is a key driver of many of the other trends in European private equity.

High dry powder levels are expected to continue, with no imminent slowdown. However, because of the buy-side headwinds discussed above, parties should proceed with caution. If PE fund managers do not deploy the funds they have raised, it could have a negative impact on their overall returns measured against capital committed. In light of this pressure and given the competitive market, the risk of making poor deals also is elevated, and the prospects for attractive returns from PE funds could diminish as a result. This, coupled with macroeconomic factors — such as the end of quantitative easing and the expectation of higher interest rates — means that investors may reduce their positions in PE funds as the potential for better returns elsewhere increases. If PE fundraising reduces, it follows that the levels of dry powder also will decrease.

[1] Sources for the data in this article are: *Bloomberg*, EY, Invest Europe, Preqin, *Private Equity News*, PwC, *Real Deals* and Thomson Reuters.

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Co-Investment Opportunities

Co-investment by fund managers and the institutions that have traditionally been their clients is becoming increasingly prevalent. The percentage of fund managers offering co-investments was up 23 percent between 2015 and 2017, to 64 percent. A number of surveys indicate that this trend has continued in 2018 because of advantages for both the fund manager and the institutional investor.

In a world of rising asset valuations, co-investment helps fund managers overcome restrictions on transaction size and capital concentration. Larger deals can be completed without having to invest alongside rival PE firms. Aside from acting as an additional source of capital, fund managers view co-investment as a way to develop stronger relationships with clients. In fact, traditional clients of PE firms are the ones that are demanding greater co-investment opportunities, thereby driving this trend. Oversubscribed fund managers have left many PE investors looking for alternative ways in which to put their capital to work. Co-investment is attractive in that it allows investors to target certain assets, with lower or no fees attached. However, as co-investment has grown in popularity (and given the importance of management fees to a fund manager's business model), PE firms are starting to push back on fee-free co-investment arrangements. The performance of the co-investment model relative to the traditional PE model is still unclear, with some fund managers believing that it slows the deal process and leads to higher costs. These potential downsides, coupled with push-back by PE firms on fees, means that the rise in co-investment may begin to slow. For now though, the upward trend continues.

Minority Investments

Growth capital — a form of private equity investment typically based on a minority stake — was found to be the most likely source of new deal opportunities in 2018. This seems to go against the conventional wisdom that a key advantage of private equity is fund managers having complete control over the businesses in which they invest. The reasons for such interest in minority investments are most likely connected to the current seller-friendly market conditions, in which any buyout attempt must overcome the rigors of a competitive auction. In contrast, a vendor in a minority deal may be looking for more than financial return. For instance, they may be interested in investment by firms that also have the knowledge and network to help the vendor expand its business internationally and are willing to cede partial control over key strategic decisions in order to obtain the investment. The thinking, therefore, is that minority investments will allow fund managers to set themselves apart from rivals through their expertise, rather than just buying power, in a market saturated with dry powder.

Subscription Lines

The use of subscription lines — loans to PE fund managers secured against investor commitments — is a developing trend, which from an investor perspective can be contentious, as it improves returns through financial engineering rather than the quality of investments by the PE fund manager. The internal rate of return (IRR) on which PE fund managers are commonly judged is sensitive to when PE investors' cash is actually put to work. Subscription lines allow fund managers to draw down PE investors' commitments at a later date, thereby improving the PE fund's IRR. In addition to altering this important metric, the cost of the interest and expenses associated with the loan will eat into any PE investor gains. On the flip side, subscription lines offer efficiency by allowing fund managers to act quickly (which, as noted above, is becoming increasingly important), since they do not have to wait for investors to fund a capital call. Furthermore, providing investors with more time to fund a capital call allows them to deploy capital elsewhere in the meantime. Given these advantages, especially to the fund managers themselves, and the low interest environment, it is unsurprising that use of subscription lines continues to be popular. The controversy that they cause may be tempered in time by a better understanding of their value and the application of other metrics to judge fund performance, thereby decreasing reliance on IRR.

Debt Funds

In July 2018, Europe's largest-ever direct lending funding closed at €6.5 billion, well above its €4.5 billion target. This is merely the latest development in a sector that has seen threefold global growth since 2007. This growth has been powered by wider diversification strategies employed by PE fund managers, filling lending opportunities left by the retreat of the banks after the financial crisis. Debt funds represented 37 percent of midmarket leveraged loan deals in Germany over the 12 months ending in June 2018 and 60 percent over the same period in the U.K. While the U.S. remains the world's largest direct-lending market, it appears that Europe is following suit.

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Brexit

A number of surveys have indicated that Brexit has had a significant negative impact on the attractiveness of the U.K. for private equity investment. In fact, a recent survey notes that U.K. PE M&A activity is down 29 percent over the past year. (However, with all other forms of M&A deal activity in the U.K. increasing significantly over the same period, this figure may actually be an indication of the competition for assets posed by corporates to PE firms rather than Brexit-related.) Despite the uncertainty surrounding Brexit, the U.K. remains a European PE heavyweight, accounting for approximately one-third of private equity activity in Europe. Furthermore, 2018 has seen continued success for British fund managers on the fundraising trail; some PE firms may even be attracted by possible investment opportunities that Brexit provides. As with anything Brexit-related, uncertainty reigns, and it remains to be seen just how disruptive the U.K.'s 2019 departure from the European Union will be for PE in the U.K. and the rest of Europe.

Conclusion

Investors do not appear to be slowing down in committing capital to PE firms, and consequently, competition for deals continues to rise. Therefore, we can expect the trend of increased asset prices and generally seller-friendly terms to continue, alongside further diversification by PE fund managers looking for new avenues in which to make returns from their increasing amounts of committed capital.

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