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The European mid-market stays the course

European private equity has a long history of outperformance in challenging environments. Despite the current geopolitical and macroeconomic tumult, LPs should be prepared to maintain the momentum of their investment programmes, write Amy Carroll and Adam Le

After a record year for fundraising in 2021 – with at least $733 billion raised by private equity managers, per *Private Equity International*'s *Fundraising Report 2021* – the confluence of soaring inflation, rising interest rates and profound economic and geopolitical turbulence means LPs have finally hit the brakes.

"We are clearly witnessing a slowdown in fundraising relative to last year," says Alexis Dziembowski, managing partner at AltamarCAM. "At the same time, there is still a record number of funds in the market."

Most LPs recognise the importance of maintaining their investment pace during a downturn. Indeed, Nicole Musicco, CIO of the California Public Employees' Retirement System, recently acknowledged that putting key programmes on hold during the global financial crisis probably cost their organisation between $11 billion and $18 billion in possible gains.

However, a dramatic public markets correction has left many investors grappling with the denominator effect. "Some investors are even facing liquidity problems," Dziembowski explains. "It's not surprising that GPs are correcting their fundraising targets."

"Everyone knows that 2021 was a great year for private equity fundraising, but the first half of 2022 has been very weak indeed," agrees Jin-Hyuk Jang, international counsel in the funds/investment management group at Debevoise & Plimpton. War in Ukraine and the ramifications for the

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International counsel, funds/ investment management group, Debevoise & Plimpton

Jin-Hyuk Jang is an international counsel in Debevoise & Plimpton's Frankfurt office. He advises sponsors on the structuring of private investment funds, as well as regulatory matters and ESG. Prior to joining Debevoise in 2017, he was a counsel at a German law firm and an associate with a US firm.

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

Richard Damming co-heads Schroders Capital's private equity investment activities in Europe, covering direct investment, primary fund investment and secondaries. Before joining the firm in 2011, he worked at Capvent, PricewaterhouseCoopers and ABB.

Alexis Dziembowski
Managing partner, AltamarCAM

Alexis Dziembowski has spent 16 years with AltamarCAM in Cologne, Singapore and London, and has more than 20 years of private equity experience. Prior to AltamarCAM, Dziembowski worked in the transaction advisory team at Ernst & Young and Arthur Andersen.

David Stephens
Partner and co-head of UK private equity, 3i

David Stephens is co-head of 3i's UK private equity team, leading its efforts in the industrial technology sector. He has worked on a number of investments including Digital Barriers, Aspen Pumps and Audley Travel. Prior to joining 3i, Stephens worked at DC Advisory Partners.

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> **RICHARD DAMMING**
> **Schroders Capital**

rest of Europe means the continent has been hit particularly hard.

"We are seeing quite a bit of hesitance from US investors, as well as some investors in Asia," says Richard Damming, co-head of private equity investments in Europe at Schroders Capital. "It is European investors that are still happily investing in the region because they understand that Europe has always been a low-growth economy, and yet – despite the GFC, sovereign debt crises, Brexit and covid – private equity has always delivered. Those factors bear no correlation to performance, and long-term investors recognise that."

David Stephens, partner and co-head of UK private equity at 3i, agrees that perceptions of tumult in Europe belie the reality, particularly on a relative basis. "Yes, Europe has its challenges, but in many ways, it's the best of a bad bunch.

"In China, we are still seeing covid lockdowns and there are geopolitical tensions elsewhere around the world. Despite the impact of war on the availability and cost of raw materials, Europe is still relatively stable, and investors value that."

Damming notes as an example that investors in South Korea are considering shifting the emphasis of their private equity programmes from China to Europe. "Institutions in Korea are heavily invested in the US and were in the process of building up their exposure to China. Europe was an afterthought. Now, China is becoming a lot more problematic for them, and Europe is becoming more interesting. The fact that Europe is stable, democratic and non-confrontational could play to the region's advantage."

"Europe is not immune to populism, of course," adds Dziembowski, "but we are still big believers in the strength of its institutions, political culture and the quality and potential of its private sector.

"Europe also boasts a great community of GPs that have delivered through

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> **JIN-HYUK JANG**
> **Debevoise & Plimpton**

the cycles and are more sophisticated today in terms of how they support their portfolio companies."

High-net-worth wagers

While institutional investment may be losing some momentum, industry participants are excited about the potential that the vast private wealth market represents. "A lot of high-net-worth investors have realised that their public markets portfolios have performed terribly over the last few months, and [they] have an increasing appetite for private markets today," says Dziembowski. "At the same time, we are also seeing more semi-liquid solutions emerging that make private markets more accessible to those individuals. That, potentially, represents a huge opportunity. Through our partnerships with private banks, we already have more than 20,000 direct retail client accounts today. Our technology platform helps us manage these relationships in a very client-friendly and efficient way – from a paperless onboarding process to state-of-the-art reporting on our online LP portal."

"Not only are we seeing greater investment appetite from high-net-worths, but we are also seeing GPs proactively approaching these groups more than they have ever done in the past," adds Jang. "The administrative effort involved in working with hundreds of smaller-ticket investors and the associated regulatory burden has previously put managers off. But some are now pursuing partnerships with wealth managers and private banks, which are creating feeder vehicles, which make everything a lot easier."

Jang adds that there are discussions underway to amend the EU Alternative Investment Fund Managers Directive regulation to expand the definition of professional investor. "I see this as a real opportunity for private equity," he says.

Damming believes the trend towards tapping into the wealth management channel is accelerating, as institutional investors are becoming highly invested in the asset class, and maybe even reaching their limits. "Historically, this has very much been an asset class for institutions, but we are certainly seeing a lot of interest from individuals in accessing the return potential of private equity," he says.

"That is resulting in a whole host of initiatives, including semi-liquid funds, ELTIFs, feeder funds and technology

The sustainability quest

Sustainability, in all its forms, has shot up the agenda for European asset management over the past two years. This is impacting private equity in a multitude of ways.

First, it is creating investment opportunities. "We are seeing increased deal activity around anything to do with the energy transition, particularly given the introduction of the SFDR [Sustainable Finance Disclosure Regulation] and the EU taxonomy," says Debevoise & Plimpton's Jin-Hyuk Jang.

However, sustainability regulation is also creating challenges for the industry. "The whole SFDR framework was poorly crafted," says Jang. "There are many unclear statements, and it is very open to interpretation. This is highly problematic for a law that has already been in place for over a year."

Meanwhile, SFDR isn't the only ESG-related legislation that the asset class is grappling with. "We have the Corporate Sustainability Reporting Directive and the Corporate Sustainability Due Diligence Directive, which will affect European portfolio companies. The US has its own ESG rules, as does the UK. Asia will probably come up with something soon as well," says Jang. "That becomes very challenging because, of course, this is a global industry. If you are setting up a European fund, you will probably be selling into the US, Asia and the UK. You have to comply with all these requirements, but sometimes the rules may be conflicting."

Diversity is another hot topic for private equity. "The industry is taking diversity seriously, but progress is still slow," says 3i's David Stephens. "We are moving in the right direction with gender in particular, and in a way covid was helpful in facilitating that, because more flexible working practices have made life easier for working mothers.

"One of our primary focuses, however, is socioeconomic diversity. The industry has historically been strong in accessing, onboarding and training individuals from the best universities and business schools. But more work needs to be done to be as successful at identifying and attracting individuals from more diverse, and less privileged, backgrounds."

platforms that bundle people together. These are exciting times because these trends are developing very quickly."

Damming adds that we are even starting to see blockchain technology being used, with some managers tokenising funds to tap into the high-net-worth channel. "The question is whether this growing appetite from high-net-worths can at least partially compensate for the slowdown in institutional investment."

Different strokes

Although the macroeconomic environment is affecting dealmaking as well, the mid-market remains relatively immune to major banking movements, Stephens notes. "There is still financing available in the mid-market, particularly at the lower end. It is more expensive, and we are spending more time than ever talking about interest curves and hedging strategies, but the banks are still there to support us."

The prevalence of private debt funds in the space is also easing the situation. "Debt funds, like private equity funds, need to continue deploying capital," says Damming, adding that he has not seen any meaningful pick up in spreads. "At the bigger end of the market, where you need to go through syndicated loans or the high-yield market, the situation is very different."

Even in the mid-market, however, you are inevitably seeing a flight to quality, says Dziembowski: "Quality deals still get funded – resilient businesses that provide essential products and services with strong pricing power and/or a high level of recurring revenues."

Here, lenders and GPs are aligned. "Managers are looking for businesses with good margins and cashflow predictability that can afford to take on more expensive leverage," says Damming. "They are obviously staying away from energy-intensive businesses, and high inflation means that consumer sentiment is terrible, so there are not many bets being placed on the consumer sector either."

Instead, investors are looking for recession-proof business models, which means Damming expects healthcare to remain popular, along with profitable, business-critical technology and B2B, asset-light services. "Of course, if you are excluding large chunks of the manufacturing and consumer sectors, that means a lot of firms will be chasing the same types of assets, which could mean valuations will remain quite robust."

Managing conflict

When it comes to portfolio management, the focus is going to be on preserving value as much as creating it, given the extreme economic and geopolitical volatility we are experiencing. Indeed, fallout from the war in Ukraine is inevitably dominating portfolio management discussions.

"There is not a single conversation had with portfolio companies today that doesn't involve the trade-off between price and market share," says Stephens. "More attention is also being placed on geopolitical issues outside of Europe. There are very few manufacturing or industrial businesses, where I spend my time, that don't have material exposure to Chinese supply chains, for example, and so the tensions between Taiwan and China are extremely pertinent."

According to Dziembowski, some GPs are asking their portfolio companies to work on contingency planning, like in the early days of the pandemic. They are looking at cost reduction and cash preservation, just so that they are prepared in case things get worse. At the same time, a lot of GPs are also focused on add-ons to take advantage of market dislocation and lower valuations, Dziembowski explains.

Those kinds of accretive value creation moves will prove critical, as exits are likely to be significantly more challenging in the months ahead. "There is often still a mismatch between sellers' and buyers' expectations, given the high level of uncertainty," says Dziembowski.

"Supply chain disruptions, inflation, higher interest rates – how will all these factors impact the growth outlook and the margins of the business I'm trying to buy? How resilient is the business really?" Dziembowski asks. "The impact is very apparent in the exit data. Distributions are falling more quickly than capital calls. We do expect an increase in GP-led secondaries deals, however."

While concentrated GP-led deals shot to prominence during the pandemic, they are likely to remain an attractive liquidity option in a market

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> **3i**

where other exit opportunities may be off the cards. It is understood that these deals primarily feature a manager's best assets, which is increasing LP acceptance of the exit route. However, conflict concerns do remain, which means fair and transparent execution is key.

"Historically, GP-leds involved less-attractive assets that remained in funds and could not be sold," says Jang. "Now the focus is on extracting maximum value by holding the best assets for longer. We often see at least 50 percent of existing investors deciding to take distribution in kind over cash. That sends a strong signal to the rest of the market: it means they really like the story."

"Potential conflicts need to be adequately managed, of course, and investors need to be sure that the GP is equipped and incentivised to further develop the asset in the future," says Dziembowski. "In particular, you need to look at the motivation of the GP. If they are struggling to raise a successor fund and simply want to extend their asset base to live off that management fee, that is obviously not the place you want to be."

Silver linings

There is no doubt that the European private equity industry is facing tough times ahead. Still, the asset class gains some comfort from its multi-decade track record of rising to the challenge.

"History tells us that in times of crisis, private equity typically outperforms," says Dziembowski. "That should encourage LPs to continue with their planned investment policy and not try to time the market."

"From crisis comes opportunity," adds Damming. "For existing portfolio companies, there will be an opportunity to target add-on acquisitions at attractive valuations. And at some point, entry valuations for new platform acquisitions should become more attractive as well."

Stephens, meanwhile, believes the geopolitical risks that exist today should not be underestimated. "We can compartmentalise economic shocks based on historic evidence, but it is very difficult to compartmentalise geopolitical shocks and how they may impact portfolios," he says. Nonetheless, he adds, private equity undoubtedly flourishes in times of adversity. "The best deals tend to take place in the most challenging economic environments." ■