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It's good to be small in Europe

The lure of higher prospective returns has attracted investors to private equity. But are they looking in the right places? US large buyouts dominate, both in terms of investor flows and media coverage, but prices are intimidatingly high as a result. Better opportunities can be found in small buyouts and in Europe in particular. This market is less well-known but that is precisely its attraction. Less competition among buyers and compelling alpha generating potential are the consequence.

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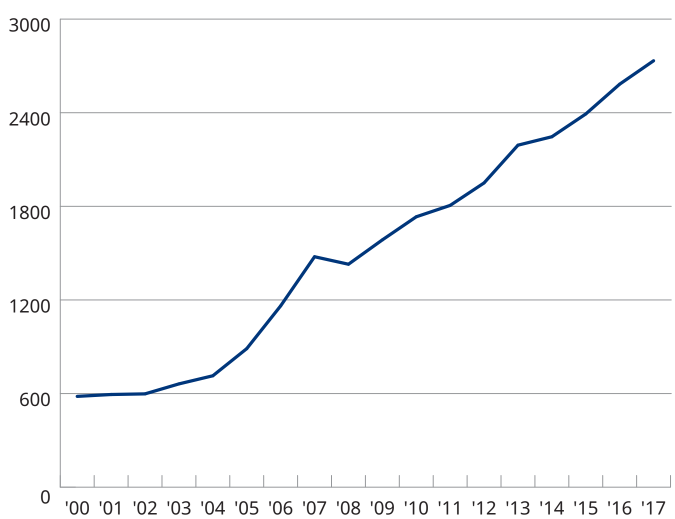
The global private equity market

The global private equity market is worth almost $3 trillion and is growing year-on-year (Figure 1). Even the financial crisis barely dented its expansion. Geographically however, most assets are invested in North America (Figure 2) and on a sector basis, most focus on the large cap buyout market.

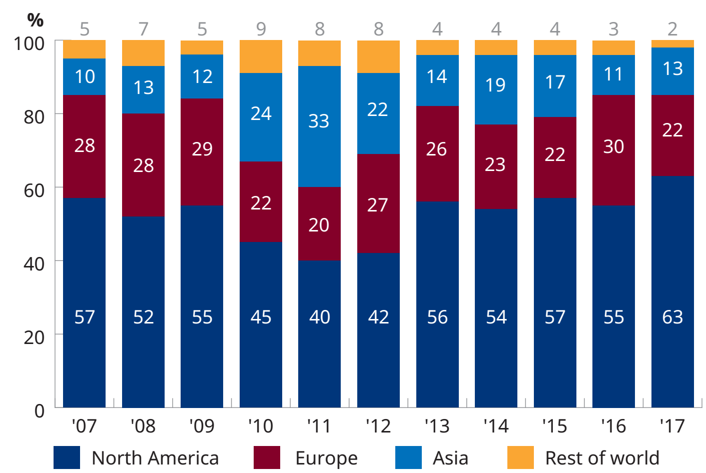
The European private equity market is notably smaller and within Europe, the small cap buyout market is smaller still (Figure 3). This reflects a number of circumstances and leads to some particularly interesting consequences from an investment perspective, as we set out in this note.

Figure 1: Global private equity assets have soared, $bn



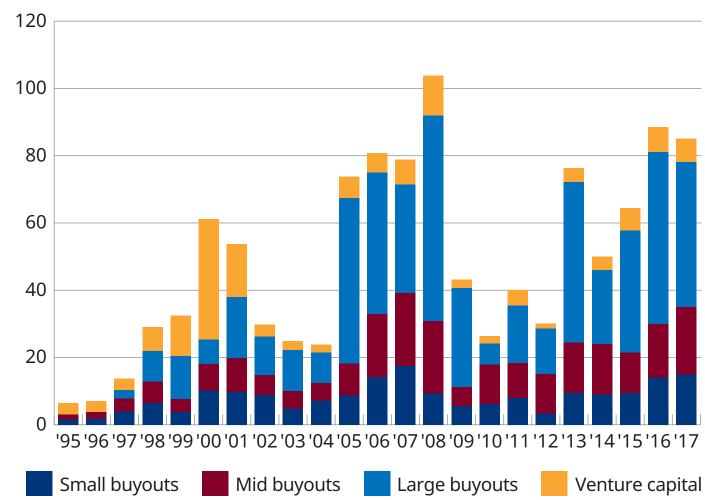
Data as at March 2017. Source: Preqin.

Figure 2: North America dominates fundraising activity, annual split of funds raised



Source: Preqin

Figure 3: European small buyout fundraising activity is more limited and less cyclical than large buyouts, $bn



Small buyout funds<€500m, mid buyout funds €500m-2bn, large buyout funds>€2m.
Source: Preqin, Schroder Adveq, 2017

Private equity added value

Private equity managers have a number of levers at their disposal to add value:

Factor	Source of added value
Market timing	Deciding appropriate entry/exit point
Stock selection	Identifying the most attractive companies in which to invest
Negotiations	The ability to negotiate an attractive entry price – easier when buying a private company, where a clearly defined market value does not exist
Operational improvements	Private equity managers take a "hands on" approach to actively managing their investments. They have more ability to effect change at the companies in which they invest
Leverage	Private equity managers can use leverage to boost their returns and instil financial discipline at the companies in which they invest

Source: Schroders

In contrast, public market investors can only easily make use of the first two sources of added value. Corporate governance efforts seek to influence some of the others and activist investors can be very vocal, but their ability to exert control is more limited than a typical private equity investor.

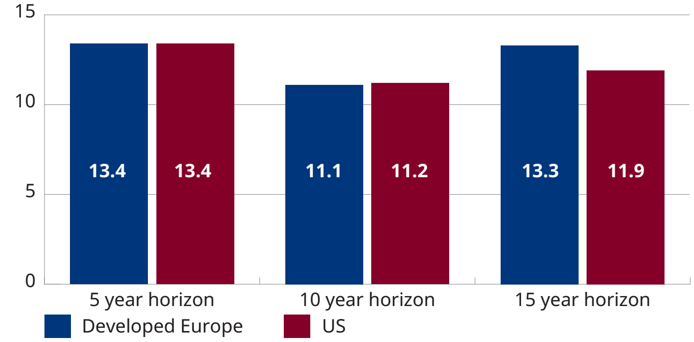
However, the proof of the pudding is in the eating. The question of how much value private equity managers add over public market investments has been hotly debated in the academic literature and wider media extensively over the years. A wide range of estimates has been put forward, from 0% to as high as 5% or more. Despite continued disagreement, a loose consensus has emerged among institutional investors that they expect private equity to outperform public equity by around 2% a year net of fees. A recent survey of 35 asset managers, investment consultants and advisors showed an average return expectation of 9% for private equity. This compared with 6.5% for US large cap stocks, and around 7% for both non-US developed market stocks, and US small and mid caps[1]. Furthermore, survey data suggests that 85-95% of private equity investors feel that private equity is meeting or exceeding their return expectations[2]. This gives some comfort to the view that private equity offers the potential to outperform public markets. In a world of depressed return expectations everywhere, the incremental value that private equity can bring is magnified.

Europe as a destination for private equity

Like a younger sibling who struggles to get the attention, Europe often has to play second fiddle to the US when it comes to private equity. Lower economic growth and, latterly, concerns over the future of the eurozone have both played a part. However, this neglect of European private equity is unjustified. European buyout performance has been at least as good as the US over medium and long timescales (Figure 4).

Figure 4: European buyout performance has matched or exceeded the US

Pooled net IRR



Performance data as of Q2 2016; calculated in euros for Europe and dollars for US.
Source: Global Private Equity Report 2017, Bain & Company

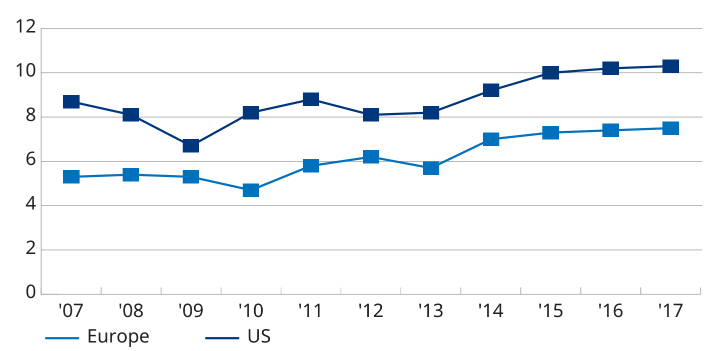
What is more impressive is that this has occurred despite Europe underperforming significantly in both economic and public equity market terms. GDP growth in the European Union lagged the US by more than 1% a year in nominal terms over all three time horizons shown above. The European equity market underperformed the US by roughly 6% a year over five years, 4% a year over 10 years and 2% a year over the 15 year horizon. The fact that European buyout funds have matched or bettered US performance against this backdrop is as clear a proof statement as it is possible to find for the potential of private equity managers to add value in Europe.

This also makes it clear that Europe does not need to outperform in economic terms for European buyouts to have a chance of outperforming in investment terms. A supportive economic backdrop is of course helpful, but by no means essential.

One reason for this outcome is that the European private equity market, though well-established, is far less crowded than its US counterpart. This means there is less competition for deals, which can allow more attractive pricing. Purchase price multiples (Figure 5) are consistently cheaper in Europe (good if you are buying, less good if you are selling). Of course, the fact that the US public equity market has also been consistently more expensively valued is also a major contributor.

Figure 5: European M&A multiples are consistently lower than in the US

EV/EBITDA multiple



Source: Pitchbook 2017 annual M&A report

1 *Survey of Capital Market Assumptions, 2017 edition,* Horizon Actuarial

2 *Preqin, investor interviews*, December 2012-June 2017

Another explanation for strong performance from European private equity is that there is greater upside potential from operational improvements. This follows as a consequence of the poorer profitability and efficiency of European companies, on average, compared with their US peers. This lower starting point leaves more room to expand.

On a cyclical basis, the European economic recovery is also at a much earlier stage than the US, which is supportive of the medium term outlook for corporate profits. Near zero interest rates also mean that debt servicing costs are especially low in Europe.

However, in relation to this final point, European private equity deals have tended to be more conservatively financed in the post-financial crisis era than in the US[3]. Clearly, characteristics vary from deal to deal and there are highly leveraged European deals just as there are conservatively financed US deals. However, this means that, on average, European deals benefit less from low interest rates and the boost that leverage can provide to returns than their US counterparts. It also means, however, that they are less exposed to credit risk if yields rise.

Of course, Europe is not without its problems. The European integration project has stalled, Brexit risk cannot be ignored and populist politics are a feature across much of the continent. Differences in language, laws, regulations and culture can also make Europe a difficult place to do business at times. However, these frictions create opportunities for those who are able to navigate them. Manager selection is especially important.

All told, there are valid reasons why Europe has struggled to attract as much capital as the US. However, these reasons also create investment opportunities for those who do participate. The investment case looks promising, despite any concerns investors may have over Brexit and the eurozone.

We should, however, beware not to judge all US private equity equally harshly. While it is true that amber warning signs are flashing in the large buyout market, much better opportunities at more favorable valuations can be found in smaller deals. The ecosystem for private equity investing is deeply entrenched in the US and the pool of potential investors is unrivalled. What it does mean is that investors would be wise to be more circumspect when investing in the US and look beyond the mainstream, particularly at this time.

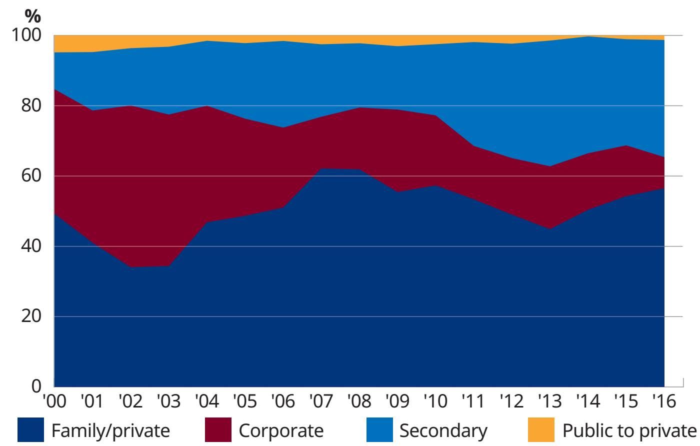
The European small cap buyout market

In Europe, we define the small cap buyout market as corresponding to companies with an enterprise value of less than €100 million and funds with less than €500 million.

This market has a number of features which make it stand out from larger transactions:

1. On the demand side, less money is raised to invest in small buyouts and these flows are less cyclical than elsewhere (Figure 3). In particular, there has not been the increase in money raised which has given rise to bubble fears in the large buyout market[4]. Ignoring any future fundraising activity (which is likely to remain strong if current trends persist), we estimate that the amount of "dry powder"[5] in the European large buyout market will take about three years to be run down. In contrast, we forecast dry powder in the small buyout market to last only seven months. The supply/demand balance is much tighter, which enables greater selectivity in choosing deals.
2. On the supply side, small buyout deals often originate from private or family businesses (Figure 6). This can avoid auction processes, and therefore benefit from limited competition for deals and more favourable entry valuations. This can be contrasted with large buyouts, where secondary transactions dominate. These occur when a private equity stake is acquired from another private equity fund. Inevitably this can result in auctions, increased competition and higher prices being paid.

Figure 6: Small buyouts deal sourcing is less exposed to auctions and competition

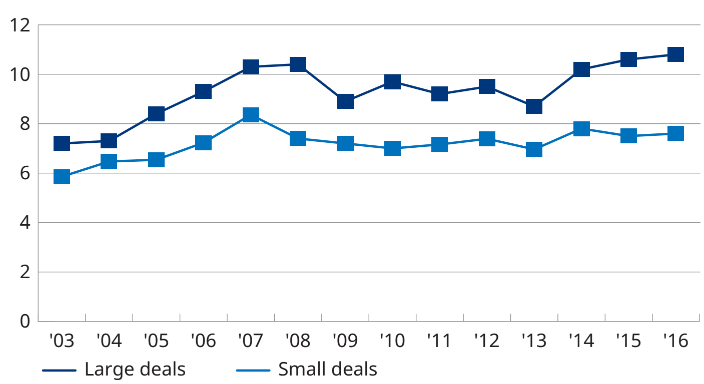


Source: Unquote Data, Schroder Adveq. Data to 2016

3. For the reasons above, as well as the additional risk of investing in smaller companies, small buyouts trade at structurally lower valuations than large (Figure 7). From a cyclical point of view, valuations have been on a rising trend everywhere but unlike large buyouts, where valuation multiples now exceed the pre-crisis peak, small buyouts are less extended.

Figure 7: European small buyouts purchase multiples are structurally and cyclically cheaper than large

Pro forma trailing EV/EBITDA multiples



Figures above are not consistent with deal multiples in Figure 5 due to different sources. This is an unfortunate but inevitable consequence of the private nature of the market.
Source: Baird, LCD S&P, Schroder Adveq, 2017

3 *Groundhog day: Is there a bubble in private equity?,* Financial Times, 24 January 2018
4 *Private equity: flood of cash triggers buyout bubble fears*, Financial Times, 23 January 2018
5 The amount of money raised but not yet invested

4. The ability to add value through operational improvements is greater in the small buyout market than large. Intuitively, it is easy to see why this is the case. Larger companies have often had multiple owners, who have all tried to eke out efficiency gains and operational improvements. The low hanging fruit has already been taken and it is harder for each new owner to add significant value. The fact that most large buyout deals are sourced from other private equity investors reinforces this argument. In contrast, small buyout fund managers are often the first institutional investor in a portfolio company. This results in far greater scope to add value by exerting influence and making operational improvements.

Conclusion

European small buyouts present a particularly interesting investment proposition. European valuations are cheaper than the US and, within Europe, small buyouts are cheaper than large. European returns have been far better than investors would have expected given the relative economic performance versus the US. The less heralded nature of Europe as a destination for private equity is its trump card and the alpha generating potential is greater for those with the skill to exploit it.

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