State of the Private Equity Industry 2016

Private equity has gone from strength to strength in recent years. On all fronts, private equity (PE) as an asset class is bigger, more diverse and more popular than ever. There is now well over a trillion dollars of capital committed to the PE asset class, just waiting to be called down and deployed. Asset prices are high and competition is fierce. When the market gets like this then PE models and strategies have to adapt. Being adaptive is part of the reason for private equity's resilience over multiple historical economic cycles.

Just how the industry is adapting now and the outlook for the industry was the topic of an evening conference in Zurich hosted by the INSEAD Private Equity Club of Switzerland (IPEC).

Fifty INSEAD alumni and guests from the banking, consulting, and private equity industries gathered in late April at an event that was moderated and organized by Martin Spirig, Partner, IPEC President and partner at Invision Private Equity in Zug. The feature speaker was Rolf-Magnus Weddigen of Bain & Company, joined by André Aubert of LGT Capital Partners, representing the institutional investor point of view and Christian Sinding of EQT Partners, representing the private equity general partner perspective.

The delegates discussed experiences and implications of current and future trends on limited partners, general partners and corporate finance advisors. A lively Q&A session followed the presentation and discussion and the event concluded with an Apéro Riche and networking.

Read on for a distillation of the presentation and ensuing discussion.

Key Takeaways

Private equity fundraising has been strong over past five years. Exit totals were also strong in 2015, almost as high as peak year 2014.

Top quartile performance well above public markets. Average PE performance is declining.

A large amount of capital or dry powder is waiting to be deployed. Investment activity could continue at the present pace over the next four to seven years even if no GP raised another fund this year.

Looking ahead industry experts expect moderate to stable growth in fundraising and slower pace of acquisitions. Assets are still very expensive.

Deal sourcing strategies are critical. Proprietary deals are rare. Local presence and wide networks are important not just for deal sourcing but also for gaining intelligence on hidden valuation and return drivers

Private equity is adopting consulting industry's retention, talent management and governance strategies to stand out from rest of finance industry and to avoid key people spinning out.

Low interest rates have caused depreciation in some competing asset classes, including public market equities. The bond market is unattractive too. These factors contribute to ever more capital flowing to private equity funds.

Private Equity's Proven Resilience

Speakers & Moderator (l to r) Christian Sinding, Martin Spirig, Rolf-Magnus Weddigen, André Aubert

Last year, despite currency volatility and macroeconomic growth problems, Private equity (PE) firms had their best fundraising year in 9 years. More than USD 527 billion in new capital was committed to private equity funds worldwide. Since 2013, PE funds have been collecting around USD 500 billion annually.

"As an asset class, private equity has proven remarkably resilient. It is unprecedented that for five years in a row, institutional investors received more capital from fund managers than calls for capital," commented Rolf-Magnus Weddigen, Partner Bain &Co. in Munich in his keynote speech at an INSEAD Private Equity Club (IPEC) event in Zurich in April 2016. He leads the number one corporate finance practice in the German-speaking region of Europe, carrying out over 300 due diligence evaluations annually.

Exits have been strong and fundraisings quick. Competition for assets is fierce and valuations of companies of all sizes are much higher than the historical norm. It means that dealmaking is not keeping up with capital raised. PE now has a record USD 1.3 trillion in capital just waiting to be invested, so-called "dry powder".

Last year, the M&A market was so robust that PE funds were even able to exit their 2007-2008 twin peak years of investments at a profit. In recent months, some managers were able to do some "quick flips", characterized as a holding period of less than 3 years.

It did not look like this back in 2010. According to Weddigen, at that time there was industry-wide anxiety about the state of private equity market. An economic boom in 2006 to early 2008 had caused PE players to fiercely compete for assets, paying prices that looked irrational by 2010.

The tried and true leveraged buyout and PE financial engineering models were deemed inadequate for the new state of the industry. News reporters and industry insiders were predicting a massive shakeout and the industry's demise. There was so much anxiety about the disruption facing the industry that Bain & Company was prevailed upon by clients to take the unusual step of producing a study to provide a perspective.

Since then the much-anticipated report (available here) has tracked how the asset class not only survived the crisis but how it keeps growing, stronger than ever.

Performance Impact

Bain and Company's analysis of the data on PE performance is that the top quartile of PE funds exhibits a healthy spread, well above public market performance. Not surprisingly, a lot of money flows to PE's top tier groups. The elite few get bigger and broader. Their fund sizes expand, their scope grows well beyond leveraged buyouts and original geographic coverage. Another effect is pressure on large fundraisers to allow co-investments from institutional investors.

Yet another effect is faster fundraisings. A proven PE house like EQT is now able to raise larger funds more quickly. "Our newer funds take 15 to 20 months. But we still have to prove our concept and our team," said Christian Sinding, Deputy Managing Partner, EQT Partners.

As fundraising momentum increases, some institutional investors query the outcome. "A fast fund raise is not necessarily an indicator of good returns," said André Aubert, Partner LGT Capital Partners AG.

The top quartile is outperforming public markets but average PE performance is not as outstanding as it once was. "The PE average and public market spread is not strong enough to compensate for the capital risk," said Weddigen, pointing out that it is remarkable that allocation across all quartiles continues to be as strong as it is.

Even PE teams that had not raised a fund in over seven years and those who are considered to be in the fourth quartile are closing new funds. "In a rational market that should not happen," commented Weddigen.

Rather than invest in fourth quartile or even average fund managers, more sophisticated limited partners choose to back first time funds, especially small highly specialized teams spinning out from larger PE firms. "It is not always the big brand names that deliver on value creation. It might even be that small teams are more successful. Small teams do the work on the portfolios themselves," said André Aubert.

First time funds are meeting less resistance but they are very closely scrutinized. There has to be a track record for each team member. The typical age range of these first time teams makes it clear that it is senior people, aged 40 to 45, making the leap and spinning out of the larger established PE houses. "They typically take a short career break before establishing their own smaller PE funds," said Aubert.

Such spinouts are in part a result of the ease of fundraising. PE firms are responding to the risk of a team spinning out in several ways. Firms are developing their brand-name to make themselves more attractive to partners and employees. Established firms are adopting the consulting industry's talent retention and governance strategies, according to Weddigen.

A team strategy and platform for talent has to be in place. There is a need to change the culture and to differentiate PE from the rest of the finance industry. PE aims to be less hierarchical and more entrepreneurial. "People are challenged to develop themselves. We offer career paths, coaching, mentoring and aim for a better life work balance," said Sinding.

Value Creation

Valuation multiples of target companies have increased, making assets more expensive than the norm. "Ten is the new 8," said Weddigen, referring to asset prices that are 10X rather than 8X earnings before interest, tax depreciation and amortization (EBITDA). With multiples like that, finding alpha or outperforming yields is challenging.

Over the years strategies have emerged beyond the financial engineering strategy on which PE was once based. Buying smaller companies as a platform and then executing acquisitions and bolt-ons, the buy&build strategy, has proven to be a way to achieve greater mulitples on exit. In fact, this type of strategy is at an “all-time high”, according to Weddigen.

But the competition for such platforms is fierce, driving up asset prices. “You see people stretching a lot to pay for a buy&build platform. They’re already calculating the value of the add-on and consolidation increase. It is like paying for the potential of a merger,” said Sinding.

The antidote is research and timing. EQT says that identifying really good companies is the first step. “One can justify paying higher multiples if there a really good value creation plan has been developed. The plan has to outline how to grow the business, investing where you see robustness and making critical operational changes,” said Sinding.

Private equity has had to become more creative. Examples of new and recently implemented strategies beyond buy&build strategy include public to private deals, complex deals, mid-market dealmaking and partnering with corporates to make large acquisitions. Some examples of the latter include Deutsche Telekom and Centerbridge making a bid for Tipico, Germany’s largest private sports betting group. Another recent example is the teaming up of Apax with Uber Technologies and Baidu to pursue Nokia’s maps business,

Partnering with corporates to acquire desirable companies rather than competing with them is a rare strategy and there are not too many successful examples of exits yet, according to Weddigen. “We have made some investments in partnership with corporates but it’s not easy. In fact, our worst deal was with a corporate,” said Sinding.

In other words, PE houses can get too creative. Back in 2006 and 2007 when valuation multiples were also very high, firms were buying minority stakes or investing in targets operating highly regulated markets. These are deal types that practitioners typically avoid. “Investing outside the core competence is a huge risk. We see it again and again with many GPs. If you stray too far, your return is not likely to be the same as your core deal type either. The need for a strategy has never been greater,” said Weddigen.

Deal Sourcing & Sweet Spots

Weddigen noted that PE fundraising was up by 16% last year but investment activity did not keep pace. In the same period, there was only a 7% growth in investments. The reason for that is simple, competition. When competition for PE assets is as fierce as it currently is, deal sourcing requires a tremendous amount of effort and patience.

Being local is one way to get an edge. EQT has deployed long term, local investment teams on the ground in several countries. It has had a local team in Switzerland since 2009. This presence contributed to its recent acquisition of Kuoni, the Swiss travel industry company. The deal was more than five years in the making. It was based on a long term relationship with key people at different levels in the company.

Proprietary deals are seldom. Almost all deals of a certain size go to auction. “Proprietary deals are not real. Even the Kuoni acquisition was not a proprietary deal. We were the ones that initiated it but there were other teams competing at the end,” said EQT’s Sinding.

Even with a local presence, PE funds still rely on a large network of advisors to improve the pipeline and source deals, according to EQT’s Sidling. Networks are important not just for deal sourcing but for gaining intelligence on hidden valuation and return drivers. “The network is also key to create value in portfolio companies,” said Sinding, adding that EQT taps a pool of advisors to build management teams, to drive change and create boards that provide reliable governance. “It takes a lot of management to make the networks work well,” said Sinding.

PE firms have to ask themselves how do I win in the PE market and how to stand out as the best in your chosen segment, according to Weddigen. “Having a focus or sweet spot is a key factor for success. And then having the team that can let you differentiate and win in the sweet spot,” said Weddigen.

Are there any sweet spots? The panelists offered a list, highlighting structural growth as promising, any substitution trends of certain technologies; Nordic infrastructure investments and cross sector trend investing, such as digitalization.

There are some long term growth prospects that are not obvious. EQT favors identifying underlying secular growth trends and then picking companies in industry sub-sectors that benefit from the growth momentum. At the moment it is information technology, Internet technology and communication, but also healthcare, both medtech and services. “They are still highly valued but there are reliable growth trends driving certain sub-sectors’ growth,” said Weddigen.

Rather than look for trendy technologies or hot sectors, LGT does its own analysis of the markets and regions, trying to understand where opportunities lie and then invest accordingly. “We don’t pick specific sectors. Exciting sectors tend to be too highly valued,” said Aubert.

What if There is a Recession?

Looking ahead, a recession has to be weighed in when performing due diligence on private equity deals today. Bain has considered the impact of a recession on PE strategy and the impact on fundraising. Not surprisingly, one conclusion is that even with low cost of debt and the ability to create value, the high entry prices paid now will slice off any decent returns in an economic recession.

A recession will affect fundraising. Excess capital to invest in PE will dry up as the exits in the pipeline decline. There will still be the over-subscribed fast raisers but the rest of funds will find it hard to raise any capital at all.

Recession or not, there is still a large amount of un-deployed capital or dry powder. “Investment activity could continue at the present pace over the next four to seven years even if no GP raised another fund,” said Weddigen.

Impressions

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Keynote Speaker

Rolf-Magnus Weddigen, MBA 92D, Partner Bain &Company, Munich

Based in Munich, Rolf-Magnus Weddigen is a partner at Bain & Company, leading Bain's German and Swiss Private Equity practice. He is a Mergers & Acquisitions expert, and has worked for Bain in Munich, Stockholm and Boston. Prior to joining Bain in 1989, he worked for companies in the information technology and bio-technology industries in England and Denmark. Rolf-Magnus has an Industrial Engineering degree from Technical University of Karlsruhe (KIT) and an INSEAD MBA.

Panelists

André Aubert, MBA 00J, Partner, LGT Capital Partners AG

André Aubert is the co-head of the Private Equity Secondary practice at LGT Capital Partners, which has been investing in the secondary market since 1998. Prior to joining LGT Capital Partners in 2005, André was a Principal at Index Ventures, a pan-European venture capital firm, which he joined in 1999 after working as a consultant for McKinsey & Company in Zurich and Geneva, advising the telecommunications and banking sectors. He holds an MSc in Telecom Engineering from the Ecole Polytechnique Fédérale de Lausanne, an MSc in Electrical Engineering from Duke University and an MBA from INSEAD

Christian Sinding, Deputy Managing Partner, EQT Partners

Christian Sinding joined EQT Partners in 1998. He serves on the EQT Executive Committee and is Chairman of the Equity Partners Investment Committee since 2011. Christian has worked in the Stockholm, Munich and Copenhagen offices of EQT Partners and opened the Oslo office in 2007. He has been involved in a number of investments including Plantasjen, Symrise, Gambro, Vaasan&Vaasan, Findus, ISS, XXL, and InFiber. Prior to EQT, Christian worked for AEA Investors Inc., a leading U.S.-based private equity firm and at Bowles Hollowell Conner & Co. investment bankers in the US. Christian holds a Bachelor of Science (in Commerce) degree from the University of Virginia, which he received with Distinction in 1994.

Moderator

Martin Spirig, MBA 06J, IPEC President, Invision, Partner