Challenging price environment: which investment strategies to choose?

Market trends – January 4th 2019

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The main indicators of Private Equity reflect a tense price environment. However, the analysis of transactions carried out by well-known European buyout managers allows us to qualify the situation and identify the appropriate strategies.

Key Points

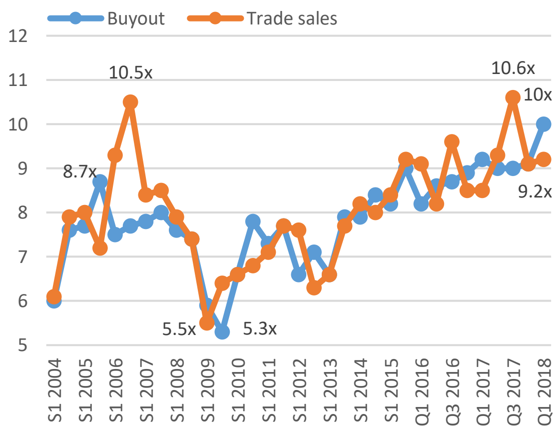
- **The main Private Equity indicators show unprecedented situation** in terms of valuations, available capital to be deployed and market activity;
- **A more favourable context for the SME segment** (enterprise value between €10m and €75m) where there are more primary transactions with a cautious approach to debt;
- In addition, **a fund manager ability to create value through the increase in company results (internal growth, external growth or operational improvements) as well as its ability to intervene in complex situations (outside auction processes) become decisive factors.**

Higher prices than at the previous top of the cycle

Acquisitions of unlisted companies by European buyout funds operating on the mid-market in the broad sense (enterprise value between €15m and €500m) peaked in the first quarter of 2018, with average valuations at 10x EBITDA. A level never reached at the previous high point in 2007.

These acquisitions multiples are comparable to those of transactions carried out by industrial acquirers and those recorded on the financial markets.

Paid multiples (EV / historical EBITDA)



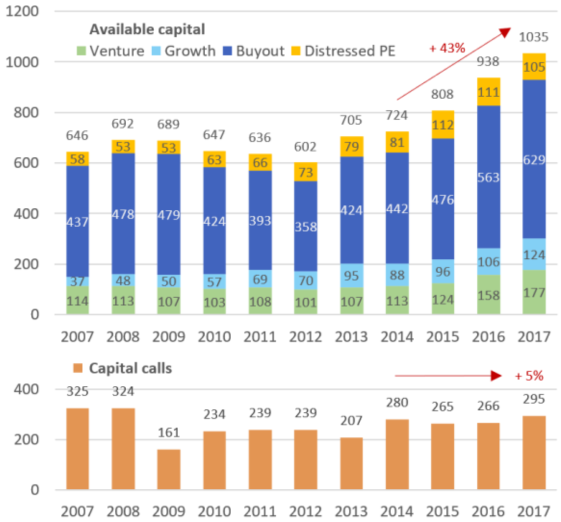
Source: Argos index, March 2018

A sustainable situation?

The acquisition price of companies paid by investment funds is not expected to decrease in the short term, for 3 reasons:

- The capital available to the funds has increased significantly in recent years, while investments have grown much more slowly. We estimate that the stock of available capital (or "dry powder") represents between 3.5 and 4 years of investment, a record.

Available capital vs. called capital ($ billions)



Source: Preqin (July 2018), ThomsonOne (Q1 2018)

- Large fund managers, that receive a significant portion of the capital committed to the asset class, raise funds of increasing size significantly. At the same time, the investment period for some of the funds has been extended from 5 to 6 years, reflecting the anticipated difficulty in deploying the capital raised while maintaining price discipline.

- New competition for purchases comes from funds with longer investment horizons ("long-term capital funds") and large institutional investors who now operate directly. These new players have lower return objectives than traditional private equity funds and may pay more.

A more nuanced situation according to market segments

Market statistics provide interesting information on average prices paid and their evolution over time, but do not distinguish between market segments.

We therefore collected information from a sample of well-known European buyout managers on the prices and leverage levels of their recent transactions (2017 and 2018). Out of more than 130 transactions listed, it is thus possible to clearly observe a hierarchy of prices and levers according to the size of the companies.

Selection of recent transactions (2017-2018)

	Upper-Mid & Large Cap (EV> €250m)	Lower-Mid Cap (€75m < EV < €250m)	Small Cap (€10m < EV < €75m)
# transactions	44	46	47
Average acquisition multiple	11.8x	9.3x	7.1x
[Min ; Max]	[6.3x ; 19.1x]	[5.2x ; 15.4x]	[2.4x ; 13.7x]
Average acquisition leverage	5.3x	3.7x	2.5x
[Min ; Max]	[1.6x ; 7.7x]	[0.1x ; 6.2x]	[0.1x ; 6.1x]

Source: Essling Capital

Transactions on SMEs (enterprise value between €10m and €75m) were concluded at moderate valuation levels (around 7x EBITDA) and with a low level of debt (around 2.5x on average). Indeed, in this market segment there are more primary transactions for which managers prefer cautious approach to debt.

At the other end of the spectrum, larger companies (enterprise value above €250m) were acquired on average around 12x EBITDA and investment funds made substantial use of debt (more than 5x EBITDA on average). These investments are more vulnerable to lower profitability or lower valuations at the time of sale. On the other hand, if the bull cycle lasts long enough, the leverage effect will boost the return on these investments.

Conclusion:

These observations allow us to make 3 recommendations:

- Do not neglect the lower part of the market, which currently presents fewer risks than the upper part. That are excellent investment funds in Europe that target SMEs and have demonstrated their ability to generate solid returns with moderate use of leverage;
- Regardless of the size of the funds and the segment, favour fund managers with the ability to support companies on their strategy of internal and external growth and operational improvement, because value creation will come from the increase in companies' results rather than from a price effect;
- Give a significant place to private equity allocation to fund managers specialised in complex situations, enabling them to acquire companies outside auction processes at average prices below market prices. Complexity can arise from the context of the transaction (e.g. scattered shareholding; delisting; carve out of non-strategic group activities; simultaneous acquisitions), the management that needs to be completed or introduced (e.g. the management of a group's non-strategic activities; family companies where the founder's succession must be organised; underperforming companies where management must be changed), strategic repositioning (e.g. changing industries; refocusing and redeployment of activities) or financial or operational restructuting (e.g. balance sheet restructuring; reduction of the cost base).

Biography

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Jean-Yves, 56, joined Essling Capital in 2017 after 22 years at Amundi, including as head of the Private Equity fund selection team since 2007.

He began his career with the Sodexo Group, then the Suez Group.

A graduate of ESSEC, Jean-Yves holds a DESCF and a Master's degree in law and is a financial analyst.

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