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Facing a stalemate

It is time for Europe's mid-market private equity firms to get back to the business of doing deals, write Amy Carroll and Madeleine Farman

Private equity deal volumes in Europe plummeted by 65 percent in the first six months of 2023, according to data from RW Baird. At the same time, *Private Equity International*'s H1 2023 fundraising report found that – despite a handful of mega-fund exceptions, including final closes from Permira and KKR – fundraising in the first half was down by around 20 percent from the same period a year prior. A dealmaking desert has dried up distributions industry-wide, preventing LPs from making fresh commitments.

Sponsors have responded by becoming even more cautious with their capital deployment as they strive to eke out their remaining dry powder, further dampening deal activity. It is clear that the situation cannot continue; something needs to break the stalemate.

"Deal junkies like me need to get back to doing more deals at scale," says Andrew Wingfield, a partner at Proskauer, at *PEI*'s European mid-market roundtable in November. "Exits are down by around 70 percent, and this has created a bottleneck in terms of providing distributions to LPs and therefore in getting funds raised. In order to give LPs the liquidity they require, we need to see more deal activity and less extensions in holding periods. Contrary to expectations, we are not in a recession. This isn't like the GFC."

Of course, pervasive economic uncertainty and geopolitical tensions are adding to this dealmaking inertia. Pierre-Axel Botuha, a partner and co-head of the French private equity team at 3i, summarises the situation: "On the one hand, there is dry powder out there. Private equity firms have money to deploy. But, on the other, we are all being very careful in this uncertain macro environment."

Vahit Alili, an investment director in the private equity team at Schroders Capital, believes that the headline statistics belie a more nuanced reality. "We have all read the recent *Financial Times* article declaring that 2023 might be the worst year for distributions in a decade, and I think that may be true for the large-cap funds that dominate the European market. But for the lower mid-market in particular, I think this will be a decent year for distributions.

"We have seen several very well-priced exits in our portfolio over the past quarter. There are still cash-rich strategics that are happy to make acquisitions, as well as large-cap funds with significant dry powder that needs to be deployed. That said, there has certainly been a flight to quality."

What's hot and what's not

Selectivity has undoubtedly intensified in this volatile environment. Only the very best assets in the most attractive sectors are changing hands. Healthcare has yet again proved its value amid these hunting grounds, alongside scalable tech. Anything cyclical, by contrast, is off the menu.

"Healthcare and tech have been the most active sectors," says Alili. "Tech-enabled companies in other sectors, such as business services, are also proving popular. By contrast, many GPs are moving away from more cyclical sectors such as consumer and industrials, although that is opening up interesting opportunities for those bold enough to take a different perspective."

Alex van der Have, managing director at MiddleGround Capital and part of the team that launched the US-based industrial specialist's European operations at the start of 2023, says his firm is a case in point. In fact, MiddleGround completed its first European deal with the acquisition of UK high-performance transmissions manufacturer and supplier Xtrac this summer.

"We only focus on industrial B2B, manufacturing and speciality

Vahit Alili
Investment director, Schroders Capital

Vahit Alili is an investment director in the private equity team at Schroders Capital. He joined Schroders in 2019 and leads the firm's buyout and growth investments in the healthcare industry, as well as fund investments and secondaries. Alili previously worked in European healthcare investment banking, most recently with Lazard and Deutsche Bank.

Pierre-Axel Botuha
Partner, 3i

Pierre-Axel Botuha was appointed co-head of the French private equity team at 3i in July 2023. He joined the firm in 2021 and was previously a principal at L Catterton, where he focused on consumer investments in Europe. Botuha has also worked at Edmond de Rothschild, BCG and L-GAM.

David Samuelson
Managing director, Nordic Capital Evolution Investment Advisory

David Samuelson joined Nordic Capital in 2010 and is now part of the Nordic Capital Evolution advisory team, primarily focused on investments in the financial services sector. He has served on the boards of 10 Nordic Capital portfolio companies and previously worked at McKinsey & Company in Stockholm.

Alex van der Have
Managing director and head of the EU investment team, MiddleGround Capital

Alex van der Have joined MiddleGround with 15 years' experience in banking and investment, most recently as managing director of private equity and venture capital at Ingka Investments, the corporate investment arm of IKEA.

Andrew Wingfield
Partner, Proskauer

Andrew Wingfield is an M&A partner at Proskauer and a member of its private capital team. He undertakes a broad range of domestic and cross-border corporate and commercial work.

distribution companies," van der Have explains. "We look for opportunities where we have strong conviction that our operations team will be able to help build a better business and therefore create value. Meanwhile, as the landscape for industrial companies has become more complex, with supply chain disruption and the energy crisis, for example, management teams are more open to the role we can play in their future. We are actively engaged in a number of processes, and we are hopeful that we will complete more deals in Europe over the next six months."

As part of its investment strategy, MiddleGround has identified three investment theses to target. First is industrial automation, where it will be investing in themes that make manufacturing more efficient, such as robotics and 3D printing. Second is infrastructure, which tackles the Western world's ageing infrastructure and the energy transition. Lastly, MiddleGround is active in the mobility sector, focusing on companies that are facilitating the transition to the "car of the future".

"A lot of investors wouldn't touch automotive right now, and there are good arguments for that," says van der Have. "But our firm has been built by automotive operators – two out of three of our founding partners began their careers at Toyota.

"Out of the more than 100 people in our firm, between 30 and 40 are operators, and more than 50 percent of those operators have automotive experience. That means we can identify which assets are well positioned for the transition to electric vehicles, for example, and [we] have extensive experience on our team that enables us to jump into operational improvements immediately. This is a space we really believe in."

"We are facing a slowdown, but I also believe this is a healthy correction. Some bad habits developed over the past few years"

VAHIT ALILI
Schroders Capital

Sector selectors

3i, meanwhile, has not shunned the consumer sector, despite its associations with cyclicality, says Botuha. "We are a listed investment vehicle investing from our own balance sheet, so we have to be disciplined in focusing on sectors and subsectors where we have strong conviction and where we think we can create value, while taking reasonable risk. We do that through deep sector expertise.

"With the benefit of that deep sector expertise, consumer remains an area where we think it is possible to find opportunities with a compelling risk/reward dynamic, specifically in the discount retail space. We have some discretionary consumer in our portfolio that continues to perform well, but we are focusing less on this segment currently."

David Samuelson, managing director at Nordic Capital Evolution, Nordic Capital's mid-market arm that raised more than €1.2 billion with its debut fund in 2021, is also a big believer in sector specialisation. In fact, the franchise has been honing its sector focus over the years.

"As a firm that has been investing for more than three decades, we believe it is vital to be able to buy and sell through the cycles, so Nordic Capital took a conscious decision to move away from industries with cyclical exposure some time ago," Samuelson explains. "We revamped our approach, and now focus exclusively on healthcare, technology and financial services, and selectively on industrial and business services. Within those broad sectors, you then need to take a more dynamic approach to selecting subsectors. The focus within financial services used to be on consumer finance, for example. Presently, we are focused on… price comparison in different segments, which caters to the price-sensitive consumer, as well as commercial insurance."

Samuelson adds that Nordic Capital is also seeing great opportunities to achieve multiple arbitrage through buy-and-build platforms where there is a clear industrial logic.

Alili counters that there has, in fact, been a flight towards organic growth, because buy-and-build plays are punished due to the high leverage that is needed in an elevated interest rate environment. However, Samuelson says that while it may be necessary to start smaller, by identifying a founder or entrepreneur rather than a ready-made platform, the opportunity remains huge: "Nordic Capital has completed four deals this year from the Evolution mid-cap fund. Three of those are M&A roll-ups. You can buy those addons at attractive valuations and then build real industrial value over time."

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>
> **PIERRE-AXEL BOTUHA**
> **3i**

Mid vs mega

As investors narrow their focus on the highest-quality opportunities in the most resilient sectors, competition for those assets is inevitably intensifying. So too, of course, is competition for commitments.

"Competition for deals and for LP money is fierce," says Wingfield. "Right now, in the marketplace there are about 14,000 GPs searching for $3.2 trillion of capital. That equates to roughly $1 of LP supply for every $3 of GP demand."

As LPs continue to consolidate relationships, mega-firms can often seem like the obvious winners in that war. However, according to Wingfield, it is not the size of the dog in the fight that counts, but the size of the fight in the dog. "There are plenty of mid-market and lower-market firms that are holding their own despite a scarcity of capital, based on their vision and strategy, including sector specialisation, as well as a clever use of people, process and technology."

The mid-market's track record of outperformance is well documented. According to Cambridge Associates, small and mid-cap deals achieved an average multiple on invested capital of 2.8x last year, compared with 2.4x for larger transactions. The caveat, of course, is that the dispersion of returns within the mid-market bracket is wider, so manager selection is key.

"I think it is quite clear that the lower mid-market and mid-market have outperformed the large-cap segment over the past 20 to 25 years," says Alili. "In my opinion, the gap will get even larger, as high interest rates mean the returns generated from leverage will be smaller than in the past.

"If you look more closely, you will see that the bottom quartile in the mid-market is actually underperforming the large-cap market. The medium two quartiles are in line, and then it is the top quartile that is dramatically outperforming, so selecting the right funds is paramount. If you end up backing an average performer, then the extra risk and volatility are not worth it."

Standing out

For mid-market managers, positioning themselves as best in class is, therefore, critical. That starts with origination capabilities. "It has become more challenging to source proprietary dealflow," says Alili. "Sellers more often hire advisers to run a professional process, even in the smaller end of the market. With a record number of GPs chasing opportunities… more specialist GPs will be able to maintain the level of success seen in the past. GPs will have to remain disciplined in the face of that competition."

For Botuha, this is where 3i's permanent capital model really comes into its own. "It means we are never forced buyers or sellers. We can invest in mid-market businesses and then keep investing until they are multi-billion-euro enterprises. We are not giving away that future upside due to structural constraints. We can continue to create value. We are also not under the same pressure to deploy capital if the timing isn't right."

In a more competitive environment, value creation also inevitably comes to the fore. LPs are looking for transformational growth, says Alili. "When partnering with GPs and making fund commitments, we analyse what proportion of EBITDA growth has come from transformational growth and what proportion from financial engineering. At least 80 percent needs to have come from the former."

3i, for example, has an approach to value creation that it calls the 'active partnership' process. "We have developed sophisticated playbooks around talent management, internationalisation, buy and build, digitalisation and sustainability," says Botuha.

"Private equity is not just about finding companies," adds Samuelson. "As competition has heated up, the ability to add real value has become critical. The way we have approached this is through sector specialisation, which allows you to develop deep expertise in your deal teams, but also in your wider network, including executives and chairpeople.

"We have also developed functional expertise across areas such as data analytics and ESG. I think that combination of industry and functional knowledge is key."

MiddleGround has also prioritised functional expertise, says van der Have. "It is a competitive market. It is therefore up to every firm to remain relevant and focused in their approach. It also means making sure you have the right people, such as operational experts, as well as functional experts. We have built an ESG team [and] a data

"The SEC is overshooting a bit with private equity, because ultimately private equity investors are extremely sophisticated institutions… Regulators are trying to take a square peg and fit it into a round hole"

DAVID SAMUELSON
Nordic Capital Evolution

Facing new regulation

What will the new SEC rules mean for private equity in Europe?

The new regulation of the private markets that was announced by the US Securities and Exchange Commission in August includes sweeping changes to disclosure requirements.

These rules, which would undoubtedly add an onerous compliance burden for those firms that fall under its purview, are now the subject of a legal challenge as market participants fight back against what they see as regulatory overreach.

"Investor protection is extremely important, of course," says David Samuelson of Nordic Capital Evolution. "But I think the SEC is overshooting a bit with private equity, because ultimately private equity investors are extremely sophisticated institutions. It rather seems like the regulators are trying to take a square peg and fit it into a round hole."

However, not everyone believes that the changes would be a bad thing. "We welcome the new regulation," says Vahit Alili of Schroders Capital. "The focus is primarily on transparency, and we believe the whole industry will benefit from that because it will make private equity more accessible to new groups of investors, which represent a sizeable amount of money and are now actively looking to gain exposure to private equity for the first time.

"Transparency will help the industry demonstrate that it is a tool for long-term growth and economic prosperity, and so we should not fear it. In the end, everyone will benefit."

science team, and an automation team that works exclusively to make portfolio companies more efficient using process automation."

The tech edge

Technology now has a critical role to play throughout the private equity investment life cycle. MiddleGround has a team working towards using data analytics to support deal sourcing and evaluation. "Developing a more efficient and insightful way to harness all the data out there to inform better decision-making will prove extremely valuable," van der Have says.

The advent of artificial intelligence, meanwhile, is poised to supercharge this journey. "We think about the potential of AI in three different areas," says Samuelson. "How can AI be used to improve the daily tasks, to improve the decision-making, and to improve the portfolio companies?

"The area that has seen the greatest impact so far is driving efficiencies in portfolio companies. We are still only scratching the surface when it comes to the use of AI to support the investment process."

Botuha agrees that AI can be a gamechanger for portfolio companies.

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>
> **ALEX VAN DER HAVE**
> **MiddleGround Capital**

He cites the example of 3i portfolio company Evernex, a provider of third-party maintenance services to data centres, for which big data can facilitate predictive maintenance and create cost savings and ESG benefits.

Wingfield, meanwhile, sits on the global AI committee at Proskauer. "We have been exploring various proofs of concept in order to see how we can improve the efficiency of drafting documents, and to ensure we use the fundraising and transactional data we hold as a firm intelligently. For us, what is important when it comes to AI is security, collaboration, connectivity, and communication – both internally as a law firm and externally with our clients."

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>
> **ANDREW WINGFIELD**
> **Proskauer**

A reset opportunity

While 2023 undoubtedly represents a low point for European private equity in terms of deal activity, there is no doubt that the European PE industry remains resolutely focused on an exciting and prosperous future.

Alili views the current hiatus as an opportunity for the asset class to reset. "Yes, we are facing a slowdown, but I also believe this is a healthy correction. Some bad habits developed over the past few years before the correction – for example, funds being deployed within two years. I don't view that as good practice. However, if you look at the big picture, there is still significant room for growth in European private equity, where allocators are still underallocated compared to their US counterparts.

"In Germany, many pension schemes still have a sub-10 percent allocation, while in the UK, defined contribution pension schemes are still often at zero. That is now starting to change, which is great for pensioners and great for economies."

While new pockets of capital opening up will undoubtedly help reenergise a lacklustre market, for Wingfield there is no substitute for simply starting to buy – and, perhaps more importantly, sell – assets once again. "To get the private equity industry functioning, we need to get capital flowing in larger quantities back to LPs so that they feel confident about investing in funds. There's a large backlog of portfolio companies that need to exit, and LPs need that liquidity.

"While many market participants are utilising the secondaries market, continuation funds, strip sales and NAV lines to get cash back into the pocket of LPs, we really need to get back to doing full exits, and at scale. In the absence of a black swan event, or an escalation of war, I don't see anything fundamentally broken here. The private equity industry has flourished in comparable interest rate environments. It just really needs to get back to the business of doing deals." ■