

## DIALING INTO EUROPE

By Mark Cecil

**F**ew private equity pros can go anywhere today without being questioned about a “China strategy.” However, an inquiry often left unasked—but just as pivotal in today’s global economy—would be, “What’s your Europe strategy?”

The fact is, a number of U.S. firms have been deploying their European strategy for years now, and many are seeing those fruits ripen today. Convention used to tell

buyout pros that the Western European market lagged the U.S. by five or even 10 years. Today many question whether there is any lag at all.

And for U.S. groups that have been waiting to see if the first movers into Europe could find success, their window may be already closing. For every generalist mid-market firm in New York, Boston or Chicago, there’s a similar group already operating in London, Berlin and Paris, and the competitive landscape resembles what they might already find domestically.



The story the numbers tell depicts a market whose growth is basically on par with its North American counterpart. A recent study issued this spring indicates that private equity groups last year raised €45.6 billion dedicated to Europe, an upwardly alpine trajectory compared to past years. The report, issued by the EVCA, Thomson Financial (publisher of *Buyouts*) and PricewaterhouseCoopers, showed that there were five funds raised last year that came in above the €3 billion mark. Even excluding those, the growth in fundraising was still 20% over the prior year.

With funding comes more investment, and Western Europe also set records in deal-making last year. A study by Incisive Media and **Bridgepoint Capital** showed that private equity deal volume topped €100 billion for the first time ever. The growth in markets outside of the U.K. help to account for the impressive totals. Activity in France nearly doubled, as the country logged €20.6 billion in private equity deal volume, while Spain made an even more impressive leap to €11.7 billion, up from just €2 billion the year prior.

While Western Europe is clearly engulfed in an upcycle, most pros operating on the continent are confident that private equity has established itself as a recognized financing

option. Unlike the venture capital industry there, which has always struggled to build lasting roots in Europe, the returns seen in the buyouts space will likely ensure the industry's long-term viability.

In the same study compiled by the EVCA and Thomson, investment in private equity is clearly shown as having paid off. Over a 20-year investment horizon, buyout funds tracked in the study had generated an average net IRR of 12.4 percent. Over a three year horizon, buyout funds had generated a 7.9% net IRR, while in a one year window, stretched across 2005, buyout funds displayed a robust 20.9% average return.

### PE Drives M&A Explosion

"For the last three to four years, the aggregate M&A in Europe has surpassed that of the States," says **David Mussafer**, head of **Advent International's** North American business. And **Daniel Farrar**, a general partner at **Morgenthaler**, describes, "There tends to be a much greater acceptance to the entire LBO community than in years past."

While the market is clearly catching up to the U.S., there are areas where it remains immature, and that is where most believe the opportunity lies. Many pros will cite that the

potential is there for a consolidation play in a number of industries, and they also believe that in certain cases there is untapped potential for geographic expansion into new continents. Moreover, some pros see the middle market in Western Europe as having been less picked over than that of the U.S., where the landscape has been gentrified by private equity and its mind set.

"On the whole there is a larger number of businesses in Europe that haven't been restructured," said Mussafer. "Europe at one point was a decade behind, but that gap has closed significantly."

The mega funds in the U.S. have made Western Europe their home away from home for a number of years now. This is partly because they have the wherewithal to support the infrastructure needed to expand internationally, but perhaps more importantly, these funds are filling an area in the market still left unfilled by the incumbent players.

"There is no billion dollar investor in Europe yet," said **Mounir Guen**, CEO of placement agent **MVision**, describing that the largest equity checks homegrown firms can hope to write still sits at around \$500 million. (Permira is reportedly nearing a final close for a new €10 billion fund,

## U.K. Taking-Privates Taking Patience

Private equity groups operating in the U.K. are struggling to impress these days.

Take the case of **HMV**. The London-based music and books retailer was approached by **Permira** in January with a taking-private offer of around £762 million. HMV dismissed the proposal within days. Permira then retooled its bid and came forward with a £843 million (\$1.49 billion) offer in March, but was again shown the door.

Scenarios similar to that of HMV are playing out all over Europe, particularly in the U.K. According to Thomson Financial (the publisher of *Buyouts*), there were \$84.7 billion in failed bids for European companies in the 2006 first quarter, a considerable climb from \$17.5 billion of failed deals logged in the previous three-month period.

Private equity rebukes were a large part of that number, as European dealmakers endured rejections throughout the market. To wit, private equity flirtations with broadcaster ITV, ports operator Associated British Ports, and retailers House of Fraser and Kesa Electricals all fell on deaf ears.

"All foreplay and no finish," is how **Barclays Private Equity** Co-Head **Tom Lamb** describes the current proclivity for rejection. He tells *Buyouts* that part of the trouble

firms are having comes in part from their past instances of success.

He cites the example of Debenhams, which was taken off the public markets in 2003 by **Texas Pacific Group**, **Merrill Lynch** and **CVC Capital Partners**, only to be refloated earlier this month in an IPO. Reportedly, the firms had already taken out over £1 billion in proceeds through dividend recaps prior to the floatation, and in the IPO also unloaded around 487 million shares at a price of 195 pence per share, which would translate into another £950 million in proceeds.

"There have been certain examples where shareholders have had it rubbed in their noses when private equity firms buy a company and a couple years later turn around and float the business at a huge profit," Lamb says.

The idea that the smart money is buying is the primary reason for pause among the public stockholders, but there may also be reticence from a company's management to open the books, as there is a fear that should negotiations fizzle there is the potential for fallout.

The wrangling between **Apax Partners** and Woolworths is one instance that may

be fresh on the minds of many targets. Apax, after months of negotiations, floated an offer to buy Woolworths for 58 pence per share. At that point, the company gave Apax access to its books. A few months later, following what the firm called "intensive commercial due diligence," Apax pulled its bid saying it was "unable to confirm certain key cash items." Not surprisingly Woolworths' public shares went in an ensuing free fall and the retailer's stock has yet to fully recover.

As buyout shops build up their war-chests, there is some worry developing that there may not be enough acquisition targets to accommodate. The collective brush-off from the public market has only heightened this fear.

However, Lamb does not anticipate that this will be a long-term issue. He notes that the stock market has enjoyed somewhat of a revitalization in recent months, and that once things turnaround, public companies will be as receptive as they once were.

"There will always be some sort of economic downturn, and when the tide goes back out, that's when people find out who's not wearing their swimming trunks." —KM.



David Mussafer

which would change that.)

However, with dollars pouring in, and continued growth among the incumbents, there is clearly more parity between the U.S. and Europe, particularly in terms of price. In fact, some argue that the market is too crowded.

"There is a lot of competition between private equity houses going on. They are prepared to pay probably more than what they originally wanted," said **Axel Fuhri**, a managing partner with Dutch boutique investment bank **Fuhri Snethlage Joosten & Flohil BV**.

This overcrowding is most apparent in the U.K. Long established as the primary beachhead for U.S. firms, the U.K. used to make up the majority of European buyout volume. As the local market has overheated, however, that number has slipped recently. Deals in the U.K. represented 26% of all Western European deal volume last year. The year prior it had accounted for a third, according to Bridgepoint.

Because of Europe's new level of competition, many firms are seeking ways to differentiate themselves. Similar to the U.S., that has meant that a number of groups are developing a sector focus and are shifting away from their generalist beginnings. It also leaves open an opportunity for U.S. firms to enter the marketplace and stand out from the crowd.

"Specialization would be a positive attribute to bring," says **Ian Leaman**, a director and founder of M&A advisor **Buckingham Corporate Finance**. "Otherwise [U.S. firms] are a quiet voice in a large crowd."

#### A Bridge Into Europe

There are a number of recent developments that continue to blur the lines between North America and Europe. Perhaps most notably, **Kohlberg Kravis Roberts & Co.** and **Ripplewood Holdings** have

tapped into the European public markets to raise capital. Given the success of KKR's \$5 billion IPO earlier this month in Amsterdam, there will likely be more U.S. firms eyeing similar floatations, and already **Apollo Management** is reported to preparing such a move.

Further, **Warburg Pincus** saw fit when it raised its most recent fund to do away with the idea that it required separate funds for the U.S. and Europe. The firm instead raised a lone \$8 billion global fund.

In another homogenizing development, the European Union is on the verge of implementing a takeover directive, which will harmonize M&A law across many countries. This will mostly effect publicly traded companies, but in general it is a sign of a cultural shift—a new receptivity to Americanized corporate ownership practices. This is particularly notable when one considers that just 13 months ago Germany's then-head of the ruling Social Democratic Party likened private equity to a plague of locusts.

Despite all the good cheer, potholes do remain. **Simon Wildig**, with London-based **Close Brothers Private Equity**, says that he has seen a few sizeable U.S. firms set up European outposts in the last several years that have still not made any traction in the market.

"Western Europe might operate under a single currency, but it is...still quite a distinct group of markets," he says. "I think there has been a view that...an investment in the U.K. or France would be an entry into the European market in general. It's not that easy."

Part of it is cultural. Common complaints regarding U.S. firms is that they aren't making enough local contacts, their language

skills are lacking and they don't keep up with local politics. Also, many U.S. firms come off as less than delicate when dealing with Europe's labor unions, which can quickly hair up deals if they are ignored or undermined. Employee protections, particularly strong in countries like Germany, Holland and France, can cool a company's ability to both hire and fire employees—an indispensable practice for LBO shops.

There are other differences as well. **Conni Jonsson**, managing partner at Stockholm's private equity giant **EQT**, said in both deal sourcing and portfolio management there are major differences between the U.S. and Europe.

As it relates to finding deals, Jonsson says that success relies heavily on reputation given Europe's less transparent marketplace. And once the deal is made, U.S. firms may run into a wall when it comes to motivating management. Jonsson cites, "[U.S. firms] think the only thing that counts is money. Lots of gold at the end of the trail isn't good enough."

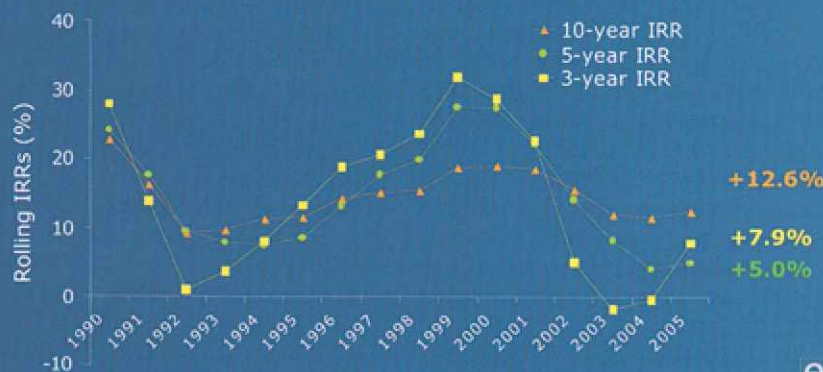
Despite these reservations, Europe is indeed becoming more friendly to U.S. investors and in many ways resembles the opportunity found on home soil. Buckingham's Leaman says, "I think U.S. investors should be seeing Europe as a reflection of their own market: a very large, continuous, active and growing economy."

But **Carl Nauckhoff**, an associate director at MVision, offers a careful reminder: "Riskkapital, capital de riesgo, capital de risque, Beteiligungskapital and capitale di rischio all mean private equity in Europe. But different cultures mean different ways to execute it." ♦

## All horizon IRRs in positive territory for buyouts and climbing

THOMSON

### European Buyouts 3-, 5-, 10-Year Rolling IRRs



Source: Thomson Financial / EVCA

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