The Truth Lies in the Exit

Creating Value in PE Assets in Europe in Times of Multiple Contraction

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With the backdrop of the year 2018 – when global and European deal volumes reached an all-time high, valuations rose to exceed pre-crisis levels and the amount of dry powder continued to grow seemingly indefinitely – it is worth stepping back from the euphoria and taking stock of the underlying fundamentals and dynamics of an industry whose progress appears relentless.

As the consistently best-performing asset class, it is not surprising that private equity continues to attract fresh capital. In the low-interest environment, Limited Partners (LPs) are seeking to deploy their funds at even higher levels within the industry, both through higher commitments as well as increasing direct co-investments on a deal-by-deal basis. With increasing competition in the market and a scarcity of assets to invest in, the market environment for General Partners (GPs) is getting tougher, thus calling for new measures of value creation to keep up the promised IRRs.

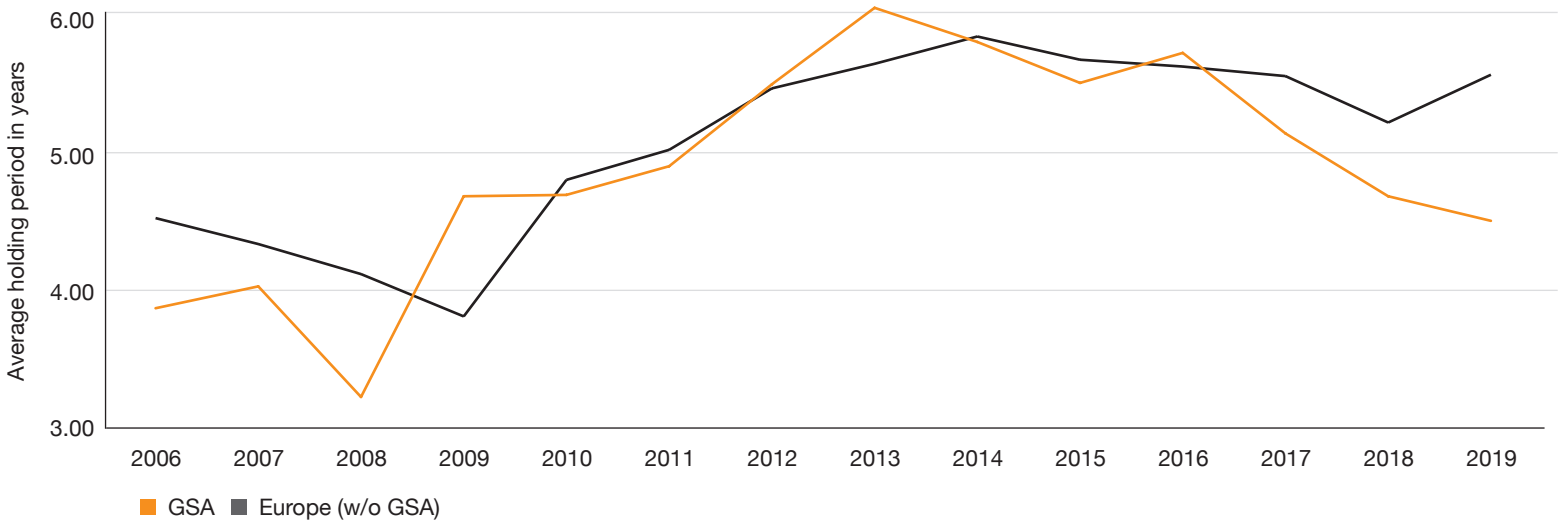
Following the classic textbook approach, private equity funds create value through three pillars (1) use of leverage, (2) multiple arbitrage and (3) operational improvement, or also known as PE alpha. Funding, including leveraged finance, is reaching record levels, enabling private equity firms to refinance on highly favourable terms and build up plenty of ammunition for acquisitions. But the easy access to leverage has to be offset against higher purchase price multiples.

Besides being benchmarked against an IRR level of up to 20%, private equity funds face the challenge of accomplishing a more balanced outcome among the main three IRR drivers going forward. As a result, operational improvement capabilities have become, and will continue to be, far more important for a private equity fund's success.

Holding periods

Another trend that has become the new norm is the constant increase of portfolio companies' holding periods. While in 2006 the average holding period for portfolio companies in Europe was 4.4 years, we have witnessed a 22% increase since then – bringing the average up to 5.4 in YTD19. This is mainly a result of increased competition and the supply of quality assets failing to match demand. Buyers are therefore paying premium prices to acquire target companies, which they need to compensate by the third factor driving IRR: PE alpha. At the same time, this factor needs more time to be implemented and generate returns before the exit can be considered.

Average holding periods in Europe vs. GSA Region



On a European level, if the long-term trend in holding periods would be linearly extrapolated, it would approach six years by 2023. Although average multiples have increased by almost 20%, from 9.1x in 2015 to 10.9x in 2018, a similar extrapolation to 2023 would mean these only reaching 10x, below current peaks. This implies that, although prices may stabilise, it is unlikely with such fierce competition for assets. The higher the prices, the deeper and longer the value creation needs to be; meanwhile, holding periods would almost certainly increase, possibly to beyond six years.

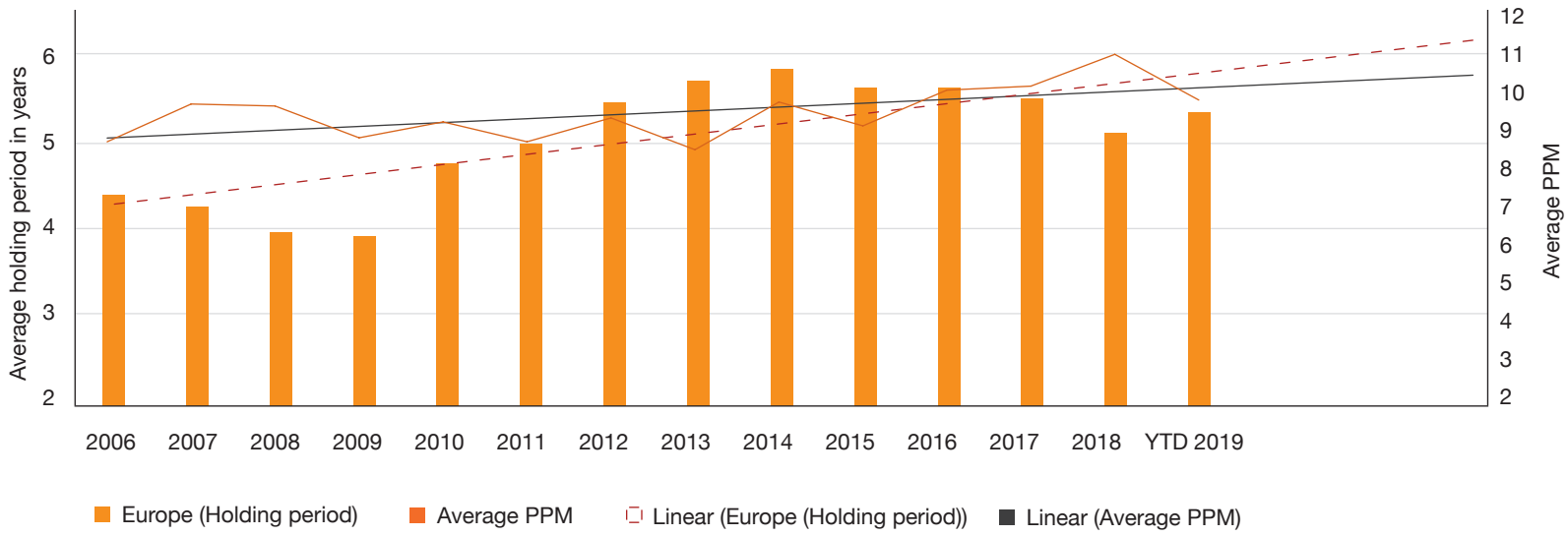
The reasons behind this development are diverse For one, one may argue that the good economic climate and safe-haven status of the region have led to an increased interest for assets, thus spurring deal-making and earlier exits of portfolio companies. The steady increase in average purchase price multiples within the same period have surely additionally supported the readiness of GPs to exit portfolio companies quicker – taking advantage of multiple arbitrage.

The high levels of dry powder and the need to deploy this capital have also fuelled secondary and tertiary deals, making PE ready buyers for these assets. However, if the development of this trend is linearly projected forward in time – average holding periods will exceed six years. Average multiples for Europe have increased from 9.1x EBITDA in 2015 to 10.9x in 2018 – representing a 20% boost. The projection following a linear trend is much more flat in comparison with multiples, slightly exceeding 10x EBITDA.

Average multiple arbitrage

When taking a closer look at the development of purchase price multiples coupled with average holding periods, we observe that in the past the private equity industry has benefited from multiple expansion, which accounted for a major part of their realised IRR. With the exception of exits in the years 2012 and 2013, which were mainly assets acquired in the highly priced year of 2007, all other years up to 2019 show a positive multiple arbitrage effect in Europe – ranging between 0.1 (exits in 2008) and 2.4 (exits in 2018).

Average holding periods and purchase price multiples (PPM)



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Looking forward, however, this effect is bound to turn. If the average current multiples (9.8x) and holding period (5.4 years) remain at these levels for the 2019–2023 period, then the exits within these years will see a multiple contraction due to the higher entry multiples paid. For exits in 2020 (acquired in 2015), the multiple effect is still positive at 0.7x; however, the 2016–2018 vintage would experience a contraction of 0.3x in 2021, rising to 1.2x in 2023. This clearly assumes no reduction of multiples or prolongation of holding periods, which would further exacerbate the projected trend. Even if multiples continue on the aforementioned linear increase, it would only avoid the contraction scenario until the 2018 vintage come to exit.

This historical development and future outlook call for a further strengthening of focus on the creation of "PE alpha", which GPs now have to work harder for and be dedicated to achieving in order to maintain the current high level of expected IRRs. Fund managers will, therefore, have to further diversify, upskill, as well as increase the headcount of their deal professionals: another challenge in a fast-maturing market that is adapting to the impact of digital and AI, to name just two major recent influences on investment decisions.

The signs of weakness in Europe's growth, the UK's withdrawal from the EU, deceleration in China, which Germany, one of the world's leading exporters, has close trading ties with, as well as a creeping scepticism and fear of a pending correction are all factors that will make equity stories more challenging to realise.

To maintain and further achieve the over performance of public markets, the private equity industry will need to continue to adapt and drive deep value creation through their portfolio companies in highly focused and continuingly innovative ways, while still finding the time and capacity to deploy capital on new deals.

In conclusion, the fundamentals of the PE market not only remain intact but also continue to evolve. Private equity has always proved resilient in adapting to an ever-changing world, with the aforementioned factors continuing in the face of asset scarcity driving further competition. The challenges are clear, however, and the track record of both performance and adaptability bodes well for further successful years ahead.

Average multiple arbitrage in Europe by year of exit