MAKING AN EXIT

Despite increasing uncertainty about the world economy and the continuation of quantitative easing, practitioners remain confident, finds Grant Murgatroyd

Extraordinary times call for extraordinary measures. Back in 2008 the global financial system was on the brink of collapse, and it was saved by the herculean efforts of governments and central banks. Quantitative easing (QE) saw trillions pumped into the financial system. Its effectiveness, in the medium to long term, may well be a matter of some debate – particularly given more recent turmoil in the world's financial markets – but one beneficiary has been the private equity industry. It has been able to sell investments and return capital to investors like never before.

"It's partly driven by QE, which means there's a lot of liquidity in the markets. This is having an effect in various ways," says Helen Steers, partner and head of European primary investment at global private equity investor Pantheon. "Debt financing is incredibly cheap, which is helpful for secondary buy-outs. Pantheon has traditionally favoured investments in mid-market buy-out funds, and this segment has seen a lot of exits through secondary buy-outs. On the other hand, corporates are cash-rich and looking for ways to drive growth. We are seeing examples of them doing that by buying faster-growing, smaller companies, which are often private-equity owned."

"Debt financing is incredibly cheap, which is helpful for secondary buy-outs"

Helen Steers, partner and head of European primary investment, Pantheon

Distributions – the money handed back to limited partners by private equity general partners – have been running at record levels for several years now. "Buoyant is a very good word for it," says Steers. "And it's sustained buoyancy in my view. We've had three record years of distributions across our business; that's driven by some fantastic exits and some good refinancings."

Buoyant is also the word used by the Centre for Management Buy-out Research at Imperial College (CMBOR). The €82bn (£63.2bn) recorded in exit value in Europe in the first half of last year put the market on track for a record value by the year-end. And indeed the year ended at a new record for exits – €153.2bn. IPO value got off to a flyer with €31bn in the first half, but slowed down, ending the year at €48.7bn. Trade sales were €31.6bn in the first half of 2015, and continued strongly into the second half, ending the year at €63.8bn (compared with €40.9bn in 2014).

HITTING THE TARGET

The mechanics of company sales have changed, with widespread auctions increasingly rare. "The element of targeting has definitely increased," says Ian Smart, partner at Grant Thornton and a former chairman of the Corporate Finance Faculty. "Owners are pretty smart these days around where they think the interest is going to be. As an adviser what you used to do for the pitch was put together a buyers list. Now you've got to the stage where information is more widespread, more readily available, therefore the owners probably know who the two or three interested parties are going to be when they start the sale process."

That is not to say that unexpected bidders are entirely absent, particularly international buyers. Smart cites the example of a UK engineering business that received an incredibly high offer from a Chinese corporate, which then pulled out of the deal during due diligence when it realised the true nature of the target. "Advisers would say that they've got a good role to play earlier in the whole process in terms of float or sale preparation and subsequently in terms of integration," says Smart.

"I think many of the advisory firms are trying to offer a more integrated service right across the timescale."

Pete Wilson, a partner at international private equity firm 3i, says that buyers are still being selective. "Demand is being stimulated by the amount of dry powder in the market and by what's still being raised. When you combine this with the leverage available, that creates a lot of competition for assets which is increasing valuations," he says. "I don't think it's the case that there is an abundance of poor-quality businesses being sold at high prices, but inevitably there is some flow through of that type of asset."

According to analysis by Preqin The private equity industry has an estimated $40bn (£27.7bn) of dry powder at its disposal, magnified by readily available debt finance. A similar amount will be raised over the coming year. "The market is incredibly busy with new fund raisings," says Rhonda Ryan, partner and head of EMEA at investment adviser Altius Associates. "There has been a bit of a rush, as while we knew that some general partners were ready to come back to market, others appear to have decided that this is a good time to fundraise. There are some groups I hadn't anticipated would be back at the end of the year."

Almost all general partners are finding substantial support from their limited partners, where Ryan urges caution. "To me it's felt toppy for two years," she says. "Prices have gone up, debt availability has gone up. Exits are wonderful – very, very strong, good multiples of cost. I continue to say to limited partners, just because you're getting money back doesn't mean that you should be going down the quality scale to redeploy it. Stick with your top managers, those that can make top quartile returns and can manage a downturn as well as an upturn."

CHANGING FORTUNES

The opportunity for private equity firms to sell the companies is often described as a window, for the simple reason that it is sometimes open and other times closed.

"The window for corporate trade sales seems to be half open, half shut and it keeps changing," says professor Mike Wright of CMBOR. "It seems to have taken quite a while for corporates to come back into the market and even now numbers are not running that high. Although we've seen some chunky deals, the actual numbers are perhaps not as high as we might have expected. A year or so ago the trend seemed to be rather more positive, but more recently the China slowdown and other things may be affecting sentiment."

The IPO window is a barometer for wider economic confidence, if only because it opens and closes with greater rapidity than the markets for trade sales, secondary buyouts or refinancings. "In the macro context we're in a low inflation, low interest rate environment," says Smart. "People have factored that in. In the very short term the relative attractiveness of different exit routes fluctuates, but on the whole the market's been fairly steady and fairly supportive of assets being realised and ownership passing on."

Wilson says that overall the forecast for the private equity industry is good, despite the inevitable clouds on the horizon. "Equity markets can be more volatile than trade and private equity because there are other factors at play," he says. "But what would cause the wider exit market to become less favourable? Significant macro shocks could certainly make people reflect a bit harder."

Steers shares concerns about the macro picture. "QE has been a catalyst, and I think everybody would agree with that," she says, warning too that interest rate rises and the large macro shocks we may well be witnessing now, 'could shut down IPO markets and knock confidence around exit markets in general'. ■

€82BN
EXIT VALUE IN EUROPE IN THE FIRST HALF OF 2015

€63.8BN
TRADE SALES IN EUROPE AT THE END OF 2015

$40BN
ESTIMATED AMOUNT OF DRY POWDER IN PRIVATE EQUITY

SEIZE THE DAY

General partners (GPs) have been focused on selling assets, but not at the expense of new deals. "We want to take advantage of what is an attractive market to sell our investments if it is the right time for those investments, but we still see opportunities for new deals," says Pete Wilson at 3i. "We are very focused on our strategy, which is around helping companies grow internationally. We believe that is a differentiator for us in the mid-market for private equity through a combination of our office network, the capabilities and international nature of our teams and, of course, our track record."

The market for new deals is incredibly competitive, with supply of capital far exceeding the population of available opportunities, with the inevitable effect of pushing up prices. According to accountancy firm BDO's latest Private Company Price Index, the average price-earnings multiple on private equity deals in the UK has risen from 9.5 times at the end of of 2014 to 10.9 times. Over the same time period, multiples on private company transactions have fallen from 11.7 to 9.3. But multiples on both counts are likely to fall, given the bearish state of the major equity markets.

Practitioners say the alarm bells are not ringing just yet. "In general GPs are being relatively disciplined in my view," says Helen Steers of Pantheon. "We have seen prices pick up in certain sectors, such as companies with defensive characteristics, where prices have been slowly increasing. Pricing is generally better in the mid-market though and where you've got some sort of complexity around a transaction."

"Although there have been chunky deals, the numbers are perhaps not as high as we might have expected"

Prof Mike Wright, the Centre for Management Buy-out Research

"Owners are pretty smart these days around where they think the interest is going to be"

Ian Smart, partner, Grant Thornton

"Significant macro shocks could certainly make people reflect a bit harder"

Pete Wilson, partner, 3i

"To me its felt toppy for two years. Prices have gone up, debt availability has gone up. Exits are wonderful"

Rhonda Ryan, partner and head of EMEA, Altius Associates