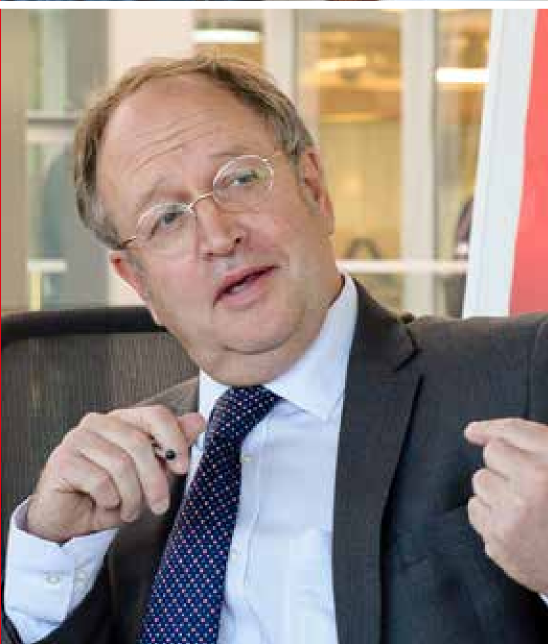
unquote" analysis

Other side of the coin
Initial coin offerings bring venture opportunities



In Profile
Tenzing Private Equity and Afinum Management examined

Diligence where it's due
Political sub-sector goes from niche to mainstream

Calm amid the storm

Industry professionals look back on a resilient year for private equity during a period of turbulent geopolitics, and consider the challenges facing the asset class in 2018

December 2017 / January 2018 – unquote.com

Beware the bullet

In early December, *unquote"* brought together a group of leading private equity practitioners to analyse industry developments during 2017, and discuss the risks associated with certain emerging leverage products

Greg Gille: It has been a turbulent 12 months, politically speaking. How has buy-side activity been and what were the key takeaways for the private equity industry from 2017 as a whole?

Peter Gale: A key takeaway was surprise at how benign the year was, from an economic point of view, a market point of view and therefore a private equity point of view. It was a very pleasant year, in terms of the conditions and performance.

David Menton: There has been a continued drive from private equity firms to deploy capital, supported by significant net inflows of new LP capital into the marketplace; GPs continue to hold a lot of dry powder. However, the number of high-quality assets that come to market appears relatively flat year-on-year. Therefore, the supply-and-demand dynamic plays a major part in driving pricing, with GPs particularly focused on acquiring high-quality assets with a high quality of earnings and predictable revenue streams. Debt funding from alternative providers is increasingly providing support to the GPs who are acquiring these assets, which in turn fuels an increasing willingness to pay high prices in M&A processes to secure the deals.

Participants

- **Peter Gale**, Hermes GPE
- **Shaun Mullin**, Investec
- **Sam Kay**, Travers Smith
- **Mounir Guen**, MVision
- **David Menton**, Synova Capital

Moderator: **Greg Gille**, *unquote"*

Key takeaways

- Buy- and sell-side activity remained relatively resolute throughout the year, despite political uncertainties across the continent
- Entry multiples are continuing to creep upwards as affordable credit remains readily available
- Concerns over the increasing prominence of capital call leverage
- Fundraising continues apace with a growing number of first-time funds, while distributions continue to outweigh capital calls
- Macroeconomic clouds could be gathering in the UK, with inflation reducing the attractiveness of consumer-focused assets
- Co-investment continues apace, as LPs look for greater control over investment strategy and governance
- Fluid politics and macroeconomic factors will continue to present challenges in 2018

Shaun Mullin: It was a relatively slow start to the year, coming off the back of the Brexit vote, as well as elections and various other factors. But momentum has picked up. We try to get a view of where the capital is coming from and where the capital is going. There have been quite a lot of first-time funds raised by proven practitioners, which are of record size. That capital needs to find a home, whether it is equity or debt. This demand, combined with scarcity of quality assets in the market, has meant we are seeing some interesting behaviours coming through. Smaller-sized EV companies structurally don't warrant as much leverage, but it's creeping up nonetheless. And as you move up in the EV range, there is far more cash chasing those assets and pushing both EV and leverage multiples up.

Sam Kay: It's been a resilient year. We expected it to be tailing off in the UK and to be comparatively stronger in other parts of the world, but that hasn't been the case. I'd exercise a note of caution in

assuming that's the case throughout the market: there is a split between groups that are able to raise new funds and do very well, and other groups that will have to work a bit harder. Broadly, it has been, and still is, a strong fundraising market. It's also a diversified market, with a range of new products that are available, so there's a lot for investors to be interested in.

Mounir Guen: There are peaks across the board – in terms of prices, volumes and distributions. Since the financial crisis, distributions have quite significantly outweighed capital calls. It's feeling unbelievably positive, but no one knows the bullet that kills you and where it is going to come from. Control investing has a lot of clout, and through control you can work through problems. More importantly, the banks are less involved than before. The breaking of covenants used to mean the end of an investment. Today, they are less involved in that activity and you have other organisations that don't use that structure. General partners understand the power of control and the ability to add value, so they're willing to pay high prices and move investments forward.

Split personality

Gille: How are wider market trends impacting on the fundraising landscape?

Guen: This is a very bifurcated system; 20 firms account for 60% of all money raised, and those 20 become continuously bigger. They are currently being backed by investors with net return targets of 11% or 12%. There's very good money in the pocket, as well as good valuations, but what happens with quality assets is that one firm can sell to another – making 2.5x money – rather than being dependent on other exit routes. The acquirer's funding base is fine with that, as long as the GP can structure that return profile for the fund to meet the net return targets. Consequently, there is a push for larger funds to be more AUM driven, so the quality of the asset and control over that asset become critical. But if the smaller and mid-sized funds constituting the other 40% of money raised started taking this selection mentality it wouldn't work.

Kay: In the UK at least, there is an element of insulating against the uncertainty of Brexit. Some of the larger GPs are accelerating their fundraising

plans, because you will have more uncertainty in 2019 compared to 2018. From a legal and regulatory standpoint, 2018 is relatively certain: you know the environment you are in and have a reasonably upbeat market. You get to 2019 and there is greater uncertainty, so why not fundraise now? Even pan-regional funds, if they are based in the UK, have to contend with marketing rules, which could all change.

Disciplined approach

Gille: If we were to see a cool down in pricing, where would that originate? Would it most likely come from scarcer financing or increased investor discipline from GPs?

Mullin: It is likely to come from the lenders, who will also look to tighten their financing structures, including reducing overall quantum and leverage, more restrictive covenants and tighter control around leakage. The catalysts for that could be numerous, ranging from greater regulatory scrutiny as they probe deeper into underlying asset classes, or from tapering and interest rates and/or currency depreciation that moves us into a tougher economic environment, which starts to move the needle on forbearance and default rates. That will force managers to reassess the risk-adjusted return of their loan books as they take stock of underlying performance through the cycle.

The bigger picture

Gille: How optimistic or concerned are you, when it comes to macro factors?

Mullin: We are quite optimistic. However, it still comes down to asset and manager selection, and who you're backing, and it has always been thus. In a high-tide environment everybody looks good; it's when the tide goes out that you get concerned and you work out what your good assets are and what aren't. We are less bullish around service sectors and anything that's got a consumer slant to it, but more bullish on others. The global financial crisis is still very fresh in a lot of people's minds and the corporate memory is long. As a bank, we have the ability to look across various asset classes and, importantly, what's going on in terms of consumer behaviour as a lead indicator. You can see a bit of strain coming through in various places, and looking at where inflation is going in the UK, that is going to start hurting people. I believe inflation is probably a little higher than people think, especially in areas such as food-price-inflation, which is starting to ramp up very quickly.

Menton: I certainly wouldn't have said I was optimistic on the outlook for 2017 at the beginning of this year, but at the same time, I haven't been surprised by the continued cycle in the private equity market over the past 12 months – the continued level of deployment of capital and valuations. We launched Synova in 2007 and invested Fund I before, during and after the global financial crisis, which encouraged investment discipline and made us more cautious from the outset – remaining very realistic about the downside on every investment even post-crisis – having experienced economic shock after shock. Being at the smaller end of the market, we focus on high-growth, niche businesses within specific sub-sectors in an attempt to decouple ourselves as much as possible from the macro. The key for us is how we identify and invest in companies we believe are resilient and are going to be protected in any type of negative scenario. We can't predict how deadly the bullet could be. Is it going to be a global financial crisis type of bullet, or just a cyclical downturn? That's what we had to build our firm through, so we are always cautious that it's a scenario we have to consider.

Guen: Within private equity, there was one particular GP that called 2008 to the dot and stopped investing. They don't exist anymore today because the net gross spread was so huge and the returns were impacted dramatically as a result. The industry

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realises there will be a day where the macro picture changes because things are cyclical, but until that day it will remain active. The confidence we have in private equity is that, if a dramatic situation happens, we have the skill-set and an infrastructure to work through it.

Gale: The industry as a whole appears to still be very optimistic. But the times of greatest optimism are when you've got to be the most cautious. I'm not proposing the right course of action is to do nothing, but one has to be wary that the good times don't last forever. Looking in the rear-view mirror and assuming that things over the next investment cycle are going to be exactly as they were over the last is dangerous. There are secular changes roaring through the world. There is one global economy and we are all subject to exactly the same fundamental forces of change. The amount of change that's going to take place during the next 5-10 years is going to be absolutely outstanding and it's uncontrollable.

On the horizon

Gille: How has the evolving debt landscape altered the behaviour of established providers, and what long-term impact do you see on the private equity market?

Mullin: We haven't quite had the same legacy as other more traditional lenders because we've only been around since the 1970s, so we're less shackled by some of their constraints. Although we have always been flexible, competitive forces dictate that we need to be more flexible and, importantly, be able to differentiate our offering to those of our competitors, but ultimately we need to be competitive. So, it has forced us to evolve and nuance our offering.

There are a lot of pros and cons for different debt products and asset classes. But we think about it in terms of: 'Where is the relative return for the risk you're taking and are we pricing that product correctly?' We needn't necessarily be worried about the emergence of covenant-light, for example. It's fine to put a product in place, so long as it works and stands up to the test of

David Menton, Synova Capital

Mounir Guen, MVision

Shaun Mullin, Investec

time, but you have to price that risk accordingly. That is probably our bigger concern: that the market is not pricing the risk it is taking correctly.

"It's fine while the music is still playing and I'm still dancing, but as soon as the music stops the fragility that's been built into the system becomes apparent"
Peter Gale, Hermes GPE

Guen: Fund financing is also interesting. We've had leverage at the investment level and at the GP level to help with cash flows, but capital call leverage is relatively new to the industry. Suddenly, people are calling one year's worth of capital cost in one go, after everything resets on the leverage facility. How does an LP budget for that and how do banks budget for this kind of awkward cash flow situation? It drives IRRs up quite healthily – calling the money as late as humanly possible – but you have a situation where, in an extreme example, general partners can draw up to 30% of a fund in one go.

Kay: I've even witnessed an investment that was made using a facility and then realised before the GP had called the money from the underlying LPs. So LPs get a return without having had to fund it themselves.

Gale: We are very eloquently describing the "bullet". This is exactly what happened in 2007-2008, where an apparently benign environment encouraged people to continuously find riskier and more fragile ways of structuring things. And that's fine while the music is still playing and I'm still dancing, but as soon as the music stops the fragility that's been built into the system becomes apparent. This leverage-on-leverage approach – making late-cycle investments where underlying return prospects have come down so you find more exciting ways of leveraging in order to juice those investments – is really dangerous.

Mullin: I completely agree. We have advisers coming to us and asking: "Do you want to do the opco debt, the holdco debt, or shall we talk to your colleagues around fund finance?" It's systemic leverage and we haven't even gone into asset finance. All the way through the stack, it's leverage upon leverage.

Gale: As an LP, you can influence GPs, but you don't have control. You can try to put governance in place, but there's not really one body that speaks for the industry. So people will get away with what they can, in terms of gearing. Everyone wants leverage because they think it's a risk-free way to juice up the IRR, which is, in reality, irrelevant – it's the money multiple that matters. All you can do is vote with your feet. We have voted. We are doing very little in the large buyout space. We're concentrating on the smaller end of the buyout and growth markets, where the industry was when I started investing 25 years ago.

Sam Kay, Travers Smith

Peter Gale, Hermes GPE

Do the right thing

Gille: A continuing theme has been that many LPs have ramped up their co-investment activity. To what extent is that driven by the opportunity for increased governance and influence over strategy?

Gale: We do 50/50 in terms of co-invest and commitments, as are many of the big Canadian investors. For us, it is specifically to get control over the investment strategy, to avoid over-leverage and to concentrate on secular growth drivers. A very large element is the governance aspect: it's actually making sure we're doing the right thing. We can't do that through the blind-pot system, but we can by partnering on a co-investment basis.

Kay: It has indeed happened in Canada and some wealth funds are also taking the same approach. But it's also beginning to happen more in the UK. You have some of the larger UK pension funds beginning to pool assets together, and the local government pension schemes have been encouraged to do just that. One of the outcomes we're seeing now as a result of that – which is becoming more prevalent in infrastructure, credit, real estate and more gradually private equity – is that these pools are beginning to invest direct and are becoming more active on the co-investment side.

Guen: The nuance is the governance on the investor side. The Australians and Canadians – and actually the Dutch and British too – have been quite creative. By changing the governance, it allows an investment professional to invest directly or indirectly. It allows

better control of the portfolio for the investors to have the risk they feel comfortable with and it's not as fee-driven. People think the growth of co-invest is fee-driven, but I don't think so. What we are seeing, as a result of this change in governance is that this definition of general partner and limited partner in the next couple of years will fade.

Kay: To an extent, it actually supports the argument that the market has matured in quite a healthy way over the past 10 years since the financial crisis. You have alternative capital through debt funds and less traditional banks, which can smooth the downside because they're not so concentrated on covenants; LPs are able to look more closely at underlying assets and have more control via co-investment; and new groups that are more understanding of what investors need are coming to the market. So it can be argued the core of the industry has matured in a good way, and become healthier and more robust for the challenges we're all predicting are going to hit.

Great alignment

Gille: Are there any types of funds in particular that are likely to perform particularly well?

Gale: In this modern environment it's all about aligning yourself with the secular trends – technology, aging population in the west, the growth of the middle-class in the east – that cannot go away. For us it is about aligning ourselves with people who think in a similar way and are aware of the problems we've been discussing, such as over-leverage, and who are doing something about it. The

Our panel's key expectations for 2018

David Menton: The key challenge is fluid politics. Continued uncertainty – whether it's in the UK, Europe or further afield – is something that will ultimately colour the backdrop. It's hard to know if that will have a direct impact on our industry in the next 12 months, or whether it will take longer. Relatively anaemic growth and inflationary pressures combined could well create a far tougher environment in the latter part of 2018 and beyond.

Shaun Mullin: Despite being the conservative lender, I'm feeling optimistic about 2018, and that's largely predicated upon capital flows. There is a lot of money in circulation and that will drive general corporate activity and M&A volumes. We'll probably see bigger deals done, with more take-privates and more bolt-on acquisitions for consolidation and multiple accretion. In terms of financing, my overarching concern is that we will see continuing loosening of terms and decreasing absolute returns as that flow of capital finds its way into both debt and equity. We'll also see more innovation in terms of financing structures at both asset and portfolio level as the hunt for yield evolves.

Sam Kay: The next 12 months will be a year of two halves. We're going to have a very good environment for fundraising to begin with and at some point it's going to pause. People will take a bit of a breather at some point. From a UK perspective, that will be based on the broader economic environment, where there will be more of a shock to the market. We will see continued bifurcation in the market between the big groups, which will consolidate assets and do well in terms of fundraising, and other groups, for which it will be more of a challenge as the big brands absorb a huge amount of attention and LP bandwidth.

Mounir Guen: It will be a healthy year. There is this shadow of Brexit, but the statistics still look healthy for the UK and Europe. The GP community is confident and is rolling ahead as if tomorrow is going to be even better. The weight of money coming in from the LP community is quite high and that's going to increase, with new capital coming from different parts of the world. The first half of 2018 will be carried by 2017 momentum, but at some point there has to be a reality check and a pause to recalibrate. With everything peaking, there are issues creeping in and someone has to start addressing them. I'm positive on 2018 but there are a few things we have to keep an eye on.

Peter Gale: It will be a fantastic year, as long as we don't have a shock from the macro – although there's a mounting risk that will happen. The fundraising of the large GPs is a terrific barometer for the top of the market. LPs are using a rear-view mirror to invest, however much they say they are looking forward. It's the track record that gets analysed and the reason is that it's easier to do that than to look forward and try to imagine. Everything is signalling a short-term top to the general buyout market – we are all going to have to work harder to maintain our premium returns.

escape routes tend to be at the smaller end of the buyout environment; the growth managers. In part it's a macro decision, but it's also about people who are cautious of what this means on a micro level and cautious about the predating model. Going forward has to be about creating exciting alpha and that needs real skill. The tide will go out, and then we'll see who has that skill.

Menton: When speaking to LPs, we don't just talk about sector expertise, but about our thematic approach and sub-sector focus. You can't just sit there and say "healthcare" anymore, because publicly funded healthcare has a big squeeze on it. For 15-20 years, everyone chased that. Now it's healthcare technology or diagnostics, for example. It's very niche. I would imagine this could be more challenging at the larger end of the market. Our investment in Kinapse, for example, culminated from a piece of targeted analysis around big pharma and the impact of the end of the "patent cliff" on margins, which is why we targeted outsourced services into the life sciences sector, to help them drive efficiency.

Guen: It's all about skillset and finding X-factors. That can be an individual with an exceptional mind that simply has the vision to take companies to a fantastic place. But it can also mean an actual firm that has put in place really good healthy governance, looks at interesting themes, has principal protection and a good dialogue with its investor base. From a geographic exposure, Europe is very exciting right now. The Nordic countries, the French, the Dutch and the Italians have been consistent long-term producers. Germany is underweight relative to its GDP and public market weighting. The Spanish had a problematic period, but now they're very dynamic again. And, of course, the UK is a real safe pair of hands. The one thing that's missing from Europe, which is fascinating because in the United States it's the trend, is super-speciality on a pan-European scale.

Kay: Although first-time funds are in vogue at the moment, it is still harder for them to raise funds. A number of the first-time funds that people talk about are groups that have been going for a while; either on a deal-by-deal basis or as a team that decide to start their own business. It's much harder for groups to emerge from other avenues now because the costs are so much greater to start up. The regulatory environment is more challenging. We would act for teams, 10 years ago, for whom private equity investing was a completely new concept. That's not so much the case now. ■