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PRIVATE EQUITY ANNUAL REVIEW
2013–2014

CONNECTIONS

IN THE MIDDLE MARKET

THE STATE OF THE EUROPEAN PRIVATE EQUITY MIDDLE MARKET

VIEWS FROM A PAN-EUROPEAN GP PERSPECTIVE

William (Bill) Watson, Value4Capital
José María Muñoz, MCH Private Equity
Karsten Langer, The Riverside Company
Dr. Andreas Fendel, Quadriga Capital
Trond Bjørnøy, Norvestor
Claudio Sposito, Clessidra
Helena Stjernholm, IK Investment Partners
Craig Donaldson, HgCapital
John Barber, Bridgepoint

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The Duane Morris 2013–2014 Annual Review of European Private Equity was prepared with the support and assistance of the European Private Equity and Venture Capital Association (EVCA).

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A LETTER TO OUR READERS

We are pleased to share with you Duane Morris' *Connections in the Middle Market PE Annual Review*, which focuses on "The State of the European Private Equity Middle Market." This report follows last year's in-depth look at the global middle market through the lens of The Riverside Company.

This year, we raised our ambitions even higher, and with the help of the European Private Equity and Venture Capital Association (EVCA), we interviewed middle-market general partners across the continent. This was both an exciting and insightful exercise, as it helped to impress upon us the very different economic, social and cultural dynamics at work across what is the world's second-largest economic bloc. It also highlighted how the private equity model is successful at creating value in a diverse range of business environments.

We kicked off our GP interviews just before mid-year, which happened to be when the Eurozone, especially the core—Germany, France and Italy—had begun showing signs of weakness after experiencing a bout of strong growth and roaring equity markets at the start of the year. What is remarkable is that the negative reverberations that transpired were well within the expectations of the GPs we surveyed. The governments of the European Union, the GPs nearly unanimously agreed, needed to press on with rigorous structural reform before real, sustainable economic growth took hold. Ultimately, what emerges is a complex portrait of challenging economic diversity and regulatory complexity. That said, Europe still rewards the strategic, diligent, disciplined and discriminating private equity player.

Our interviews with the GPs covered a broad range of subjects—from the state of the deal market to the macroeconomic climate, to private equity's image. Duane Morris is proud to share with you the highlights of our conversations, along with related supplementary research, commentary and data. We think that taken together, the narrative paints a compelling story of the asset class' largely unrecognized role in putting capital to work to build stronger, fast-growing businesses, while creating value for long-term institutional investors.

Duane Morris would like to thank both the GPs we interviewed for sharing their time and insights with us, as well as the EVCA—both were instrumental in enabling us to develop this important report. We welcome your feedback and questions as we remain committed to advancing the dialogue and understanding about middle-market private equity. Thank you for your interest.

We hope that you find this issue in our *Connections* series both informative and thought-provoking.

Very truly yours,

George J. Nemphos
Global Chair of Corporate Practice Group and Co-Head of Private Equity
Duane Morris LLP

Pierfrancesco Carbone
Co-Head of Private Equity – UK / Europe
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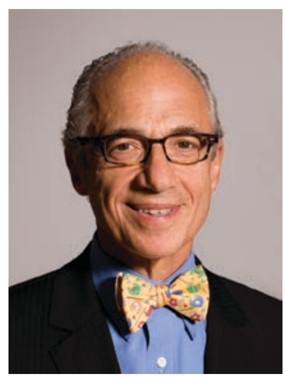

Richard P. Jaffe
Co-Head of Private Equity
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VIEWS FROM A PAN-EUROPEAN GP PERSPECTIVE

Our Contributors

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HELENA STJERNHOLM, Partner at IK Investment Partners – Pan-European mid-market private equity with Nordic roots

CRAIG DONALDSON, Head of Business Strategy and Client Services at HgCapital – UK-based, offices also in Germany; invests in Europe and the Nordics

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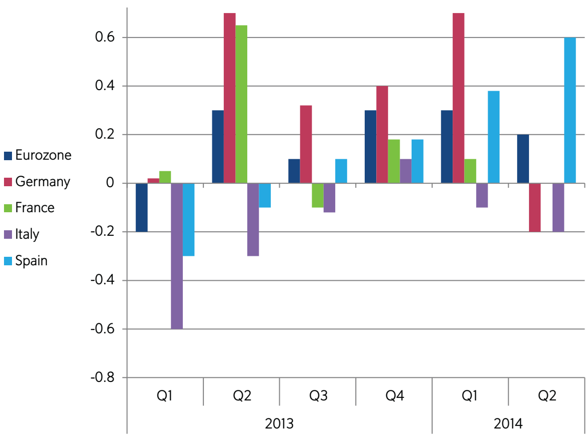
INNOVATIONS IN GLOBAL
PRIVATE EQUITY LAW

MACROECONOMIC OVERVIEW–
The Economic Ground Continues to Move

Timing can be everything. In April and May 2014, we interviewed middle-market GPs across Europe. A consistent area of consensus in our discussions was that nearly all believed the European economy was recovering—yet, the expectation was for low to no growth in the near term. We took this feedback as telling, given how diversified our pool of GPs were geographically.

The sentiment that this was to be the year that the Eurozone recovery took root was broadly held given the optimism at the year's start that economic growth would recover in countries such as Spain and Italy, all of which appeared to be anticipated by the rising European equity markets. However, just as we began our discussions, growth was stalling in the 18-nation currency union's core as Germany, which accounts for nearly 30 percent of Eurozone's gross domestic product, shrank by 0.2 percent; France, the second-largest economy, came to a standstill; and Italy, the third largest, fell back in recession for the third time in six years[1] (See Chart 1).

Chart 1: Eurozone GDP Growth Stalls



Source: Eurostat

By June, the European Central Bank (ECB) responded by launching an extraordinary monetary easing program. Besides festering geopolitical tensions in the Ukraine and Middle East, there is a growing awareness that member states are not implementing the structural (labor, pension, market and tax) reforms necessary for sustainable growth. Mario Draghi, the ECB chief, has called for Brussels to be given new powers to oversee reforms—moving the Eurozone closer to a political union, an outcome that is not widely accepted.

Turning now to our GPs in the field, it is remarkable that they sense the stirrings of economic growth in the region's periphery, such as Central and Eastern Europe (CEE), Greece and Portugal. Moreover, operating at the lower and middle markets where building sustainable businesses is their job, the GPs are staunch supporters of structural reform, as they see it as essential for creating more competitive and productive markets to drive economic growth.

John Barber, a Partner at Bridgepoint, which invests across Europe but principally in the UK, France and Germany, says his group's "operating assumption is slow-to-no growth," which means "we can't look for any rising-tide effect from a stronger economy." José María Muñoz, a Founding Partner at MCH Private Equity, which is focused on the Spanish market, sees "a stable environment but not a lot of growth."

Europe's weak economic performance has its upside. After being perceived as too risky, it is now "perceived to be somewhat of a value market compared to the U.S.," says Karsten Langer, a Partner at The Riverside Company, based in its Belgium office. "If you look at Spain or Greece, in 2014, they should achieve for the first time positive growth after an era of significant decreases," added Dr. Andreas Fendel, a Founding Partner at Quadriga Capital.

Supporting the turnaround consensus is the fairly widespread belief among GPs that the bigger risks and uncertainties facing the continent are off the table. In Barber's view, "The really extreme macro risks have receded, very materially," and he does not think "any sensible person thinks the Eurozone is going to break up." Claudio Sposito, a Founder, Chairman and CEO at Clessidra, agreed, saying "The question of the sustainability of the European Union as an economic model appears to have been put behind us." Langer pointed out that the two countries on the critical list, Greece and Portugal, "were able to conduct very successful bond issues."

Challenges and Uncertainties Ahead

European middle-market GPs see more than a few risks on the short- and long-term horizon. In Fendel's opinion, "The key challenge comes from monetary policies" where right now, "it is positive," but down the road, "creates risks to GDP." He also worries about the "strong tendency to over-regulate," particularly because of the potential impact on capital markets. In Muñoz's view, demographic issues and internal demand together are making the need for reform "inevitable." A big, uncontrollable risk, in Langer's opinion, is the continuing tension between Russia and Ukraine.

Another point of agreement for the GPs is that the European economy is not monolithic, but instead a politically and economically diverse set of countries that are in very different states of development. Sposito notes that "There are very significant unbalances among the different regions of the continent." At a minimum, Fendel thinks the continent should be differentiated between north and south, and for the north, he says, "The economic outlook is pretty good, as it is very much the beneficiary of monetary policies in combination with a strict household discipline."

Regionally, the GPs could point to an improving picture, although not without some challenges. Trond Bjørnøy, a Partner at Oslo-based Norvestor, noted Norway has a few things going for it, including strong government finances, low unemployment, a highly skilled labour force and the world's largest sovereign wealth fund. Yet rising costs are "a continued challenge for labour-intensive industries, but create possibilities for companies with sophisticated supply chains and automated services."

Central Europe is rapidly maturing and becoming a sophisticated economy with an active stock market, the Warsaw Stock Exchange, says Bill Watson, a Managing Partner at Value4Capital. He notes: "A good portion of the deal flow like everywhere else is intermediated," and unlike the past, "we don't have to convince some multinational M&A director that is arriving in Poland for the first time that this is a great place to be." As the region matures, he is seeing "an increasing divergence amongst the different parts," which he notes translates into the need for country-specific or sub-regional-specific strategies.

Southern Europe, probably the region that has received the most negative attention in the press, is staging a comeback. According to Langer, the region "is relatively well-valued at the moment." That said, Sposito notes that the Italian private equity market is at least 10 years away from being a fully developed market. The complexity of the market, he says, gives domestic players a competitive advantage; at the same time, it is rich with middle-market companies—"There are thousands of companies, most of which are export-oriented, technology or design-oriented, family-owned." In his view, "It is an ideal territory for a mid-size fund."

Barber summed up an important advantage Europe has had—especially over developing

regions—and that is "the quality of the market." In his mind, Europe is "the best play on a risk-adjusted basis among the major private equity markets." For him, the attractions include "strong corporate governance, the availability of majority control transactions, the sophistication of financial markets, the depth and liquidity of financing and equity markets, the quality of management you can attract, as well as the quality of franchises, and the capacity to pursue very sophisticated business plans."

Europe has seen change and it hasn't made doing deals easier. "Twenty years ago," says Helena Stjernholm, a Partner at IK Investment Partners, "there would have been less competition, and the market was less efficient. Therefore, it was easier to do good deals." With a more mature and transparent marketplace, and a more level playing field, she observes, returns are likely to decline.

"It's also difficult to work in a less transparent and less structured market," she notes, and "it sounds like a dream to have a very unsophisticated market, where you can do things in a more proprietary way, but it is not." Europe, says Barber, "is just a very interesting investing landscape. Would I say it's easy? No. Would I say it is interesting and ripe with opportunity? Yes."

RECOVERING DEBT MARKETS AND NEW CREDIT FUNDS

The transformation of the European debt market may have been one of the bright spots in the continent's financial scene during the first half of the year, which was in part driven by a shift in corporate fundraising from bank balance sheets to more direct capital market activity. Thus, high-yield deals saw their best-ever first half and investment grade debt saw its best first half in three years, according to Dealogic.[2] The "hunt for yield" has encouraged an expanding group of institutional investors to become non-bank lenders, making the private debt market a viable alternative financing channel.

As the European economic recovery looked to get under way early this year, most European GPs did not see any real constraints in accessing debt. There was wide agreement that in response to poor economic health and the pullback by banks, the market was seeing new instruments and new credit funds, which were helping to fuel buyouts, recaps and company growth. What was surprising—and encouraging—is that not only larger private equity groups, but also middle-market firms, can access this liquidity.

"We see very liquid markets, we see a strong appetite for risk, EBITDA debt ratios are increasing—we see leverage ratios of more than five times EBITDA," is how Fendel at Quadriga saw lending markets shaping up. Indeed, the last time he saw debt financings ratios like this was shortly before the 2007 financial collapse. It is generally recognized that while overall credit availability has improved, it remains tough to get things done in peripheral countries, and ultimately, financing for the business is very asset-specific.

Thanks to having very strong banks that were not as affected by the financial crisis as their European competitors, Stjernholm at IK Investment Partners says, "It's not difficult to get the financing from the large Nordic banks, and we have a very good bond market." IK recently issued a bond in one of its Norwegian companies, VPS, on what she said were "very good terms and which was over-subscribed," indicating "a strong alternative to the banks." That said, she notes that the value of strong

EUROPEAN DEBT MARKET BECOMING MORE LIKE THE U.S.—TO THE BENEFIT OF MIDDLE-MARKET PE

A recent report by Marlborough Partners indicates a dynamic and evolving European debt market:

> Total private equity loan volume in Q2 was €22.3 billion, average senior and total leverage multiples reached 4.8x and 5.0x, respectively (as against 4.4x and 4.7x in the whole of 2013).

> Average equity contributions were 43.6 percent but reached 42.0 percent in secondary buyouts, the lowest level since 2007.

> H1 2014 has seen 66 refinancings and recapitalizations, as compared to 62 in H1 2013.

> European market is moving toward cov-lite structures—U.S. cov-lite issuance accounted for 62 percent of all institutional new issues in H1 2014; European cov-lite deals recorded a high of 14 percent of all outstanding loans now lacking maintenance covenants, compared with 6 percent at the end of 2013.

> Cov-lite issuance in Europe has now reached over €10 billion, eclipsing 2007's level of €8.1 billion.

> Blending of U.S. and European terms in the large market is creating increasingly favorable terms for borrowers and some of this is filtering into the mid-market, which is resulting in sponsor-friendly terms for deals of all sizes.

> The institutional market is also coming down in size—whereas 18 months ago, €250 million was the point at which one could access the institutional market, it is now moving closer to €150 million.

> The U.S. market is a key driver of the evolution, as many European borrowers started tapping into it around 12 to 18 months ago, forcing European lenders to compete.

Source: Marlborough Partners, "Increasing Convergence Between Large and Mid-Cap Structures," Q2 2014 Market Update, August 4, 2014 relationships with local banks really comes through in tough times.

2 out of every 3

institutional investors surveyed are considering or are investing in private debt funds.

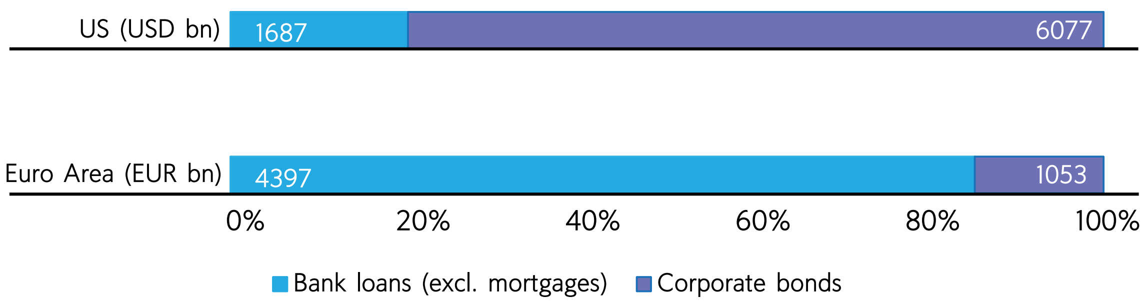
Source: Preqin 2014

The last two years have seen a spike in the number of European high-yield bond issuances.[3] Barber at Bridgepoint also noted that they were beneficiaries of a burgeoning high-yield market, which he said was available "selectively" to assets of a certain size and profile, and which have few covenants. "We do not find a high-yield bond fits with most of our types of assets, but it is definitely a financial instrument that was not available to us three or four years ago, and that now is on an occasional basis."

Norvestor also recently completed very successful bond issues for several of its industrial companies. Observes Bjørnøy, "There is a lot of interest at quite attractive pricing," but he isn't optimistic that the opportunity will last. He points out that "It is very attractive financing, especially for our growth companies." Bjørnøy highlights benefits, such as "bullet and covenant light structure, and competitive pricing compared to senior debt in banks," that make it "obvious that we will take advantage of it."

Central Europe is also experiencing a healthy availability of lending. "In Poland, there is availability of prudent levels of debt for good deals," says Watson at Value4Capital. He adds, "Part of that is driven by the size and scale of the Polish market and deposit base and the fact that the banking sector here is well-developed." He adds, "If you go to Romania, where the banking sector is under more pressure and is not as strong from a balance sheet point of view, liquidity is

Chart 2: Sources of Non-Financial Corporate Financing



Source: Swiss Re, Infrastructure Investing. It Matters, Institute of International Finance, 2014, p. 25

reduced and the lending hurdles higher." And while mezzanine has been available for years, "Private debt funds haven't penetrated Central Europe yet," he adds.

In Spain, the "economy is in a rush to deleverage," says Muñoz at MCH Private Equity, and with banks putting pressure on companies to reduce their lines of credit, an opportunity has opened up for alternative credit providers. He sees renewed interest from U.S. investors who are looking to Europe on the debt side. Moreover, says Muñoz, there is considerable room for intermediated debt, including private equity debt funds, to grow. "When you look at how much of the financing economy is intermediated through banks in the U.S. versus Europe, the difference is pretty striking," he says. Europe, he observes, "is 90 percent or more bank dominated, while in the U.S., banks represent something like 30 percent of all the financing that goes into corporations."

In a breakout of non-financial corporate financing, SocGen found that the split between bank loans and corporate bonds was about 20/80 in the U.S.; in Europe, it was over 80/20 (See Chart 2).

A big driver of the wave of new instruments and credit funds is "the need that many investors have for yield in a market where interest rates have been very low for a long time," says Langer at Riverside. He also notes Europe's need to move toward a greater degree of so-called disintermediated lending and sees "insurance companies, debt funds and other non-bank institutions doing direct lending." Langer notes that it creates an opportunity for private equity in two ways: "It brings new lenders into the market, which recreates competition that was absent in the last few years and replaces some of the liquidity that went missing; and for some PE managers, it creates an opportunity to raise debt funds and become a supplier in that market, which some have done."

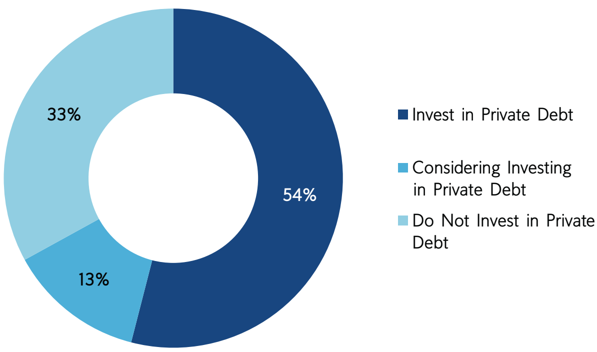
78%

of investors prefer direct lending funds when investing in private debt.

Source: Preqin 2014

Institutional investors' interest in investing in debt is growing. In a recent survey, Preqin found that more than 50 percent invest in debt and those that do have a mean current allocation of 5.6 percent (See Chart 3).[4] The minimum mean target rate of return for private debt was 8.56 percent, with 13.95 percent as the maximum mean return.

Chart 3: Proportion of Institutional Investors Investing in Private Debt

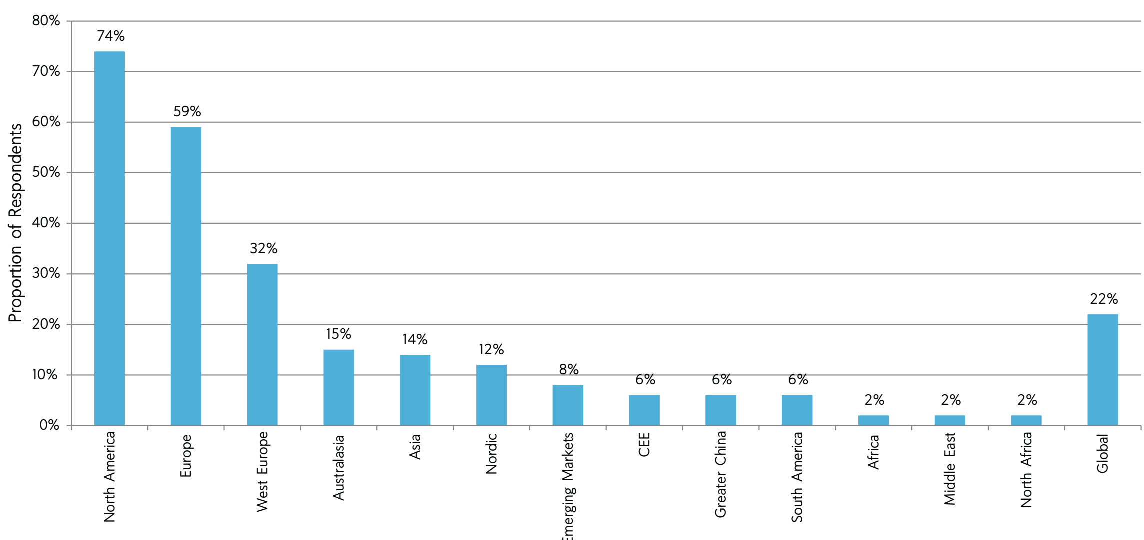


Source: Preqin, Special Report: Private Debt—The New Alternative? July 2014, p. 3

What regions do institutional investors look to invest in private debt? According to Preqin, Europe follows closely behind the U.S. as the most-sought-after market (See Chart 4). What makes these markets attractive is not only the opportunity to put money to work, but also stable and transparent legal systems and plenty of market intelligence—all of which risk-tolerant investors require to gain comfort.

While dark clouds are appearing again over the continent's economy, the good news is that its debt markets have begun to evolve, to the benefit of borrowers, especially at the lower- and middle-market segments. And by late July, Wolfgang Kuhn, head of pan-European fixed income at Aberdeen Asset Management, observed that "The outlook for credit in Europe is good, partly because of the ECB's willingness to keep pumping liquidity into the economy."[5]

Chart 4: Institutional Investors' Geographic Preferences When Investing in Private Debt



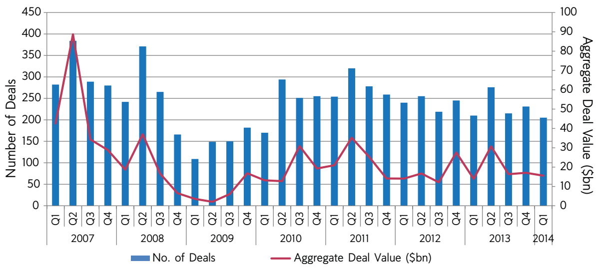
Source: Preqin Special Report: Private Debt: The New Alternative? July 2014, p. 6

THE STATE OF THE DEAL AND EXIT ENVIRONMENTS

Looking out at the market in late spring, European middle-market GPs agreed that the greater availability of debt was a leading contributor to the deal market, which was beginning to simmer at least by the half-year mark. When we interviewed GPs, there was a worrisome consensus that the market was becoming overheated, which was echoed across the financial pages.[6] In addition to accumulating dry powder, investors and strategic buyers were returning to the market. The frothy market had one clear upside for private equity—it meant it was a good time to exit.

European deal activity saw an over 10-percent increase in deal value from 2012 to 2013, as sentiment in the continent's economic outlook changed for the better (See Chart 5).

Chart 5: Number and Aggregate Value of Private Equity-Backed Buyout Deals in Europe, Q1 2007 – Q1 2014

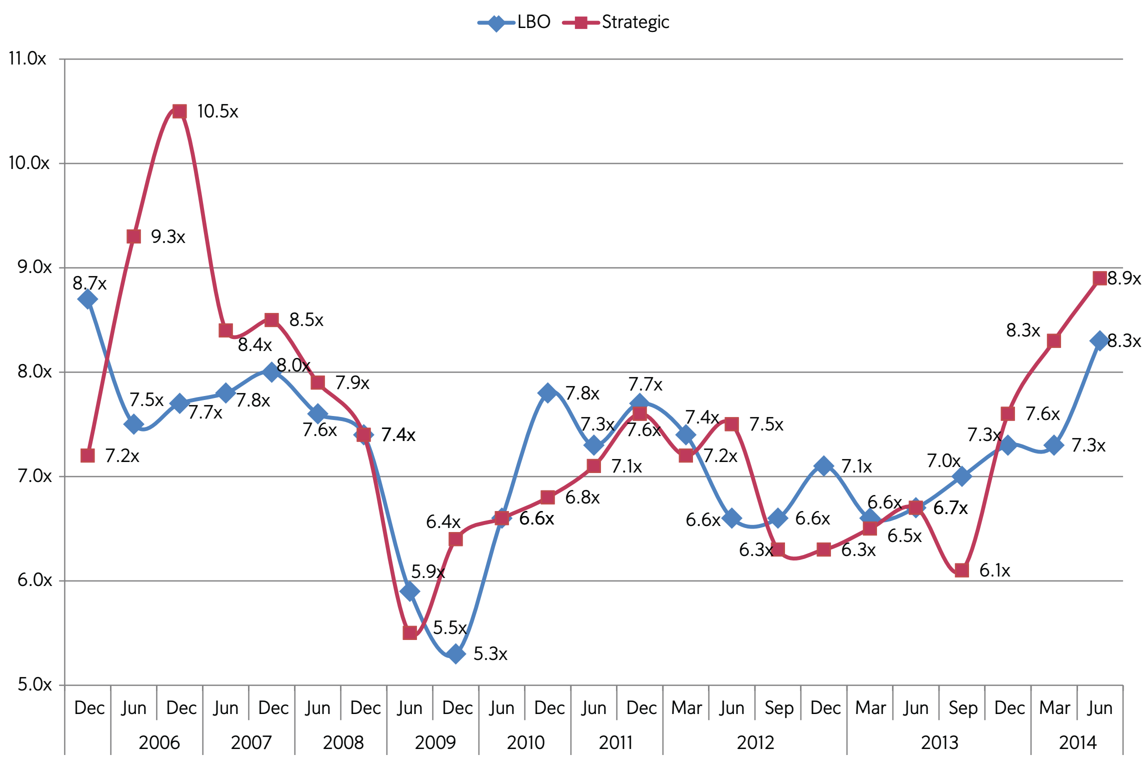


Source: Preqin, Private Equity Spotlight, April 2014, p. 5

The rise in lower mid-cap valuations during 2H 2014 was captured by Argos Mid-Market Index (See Chart 6). In the €15-150m segment across Europe, the median value was 8.6x EBITDA in Q2 2014, which marked the highest point reached by the index since the second half of 2006, when the median entry multiple stood at 9.1x EBITDA.[7] For the broader market, the average multiple for European deals was 10x trailing EBITDA, above the pre-crisis peak of 9.7, according to S&P Capital IQ LCD.[8]

The much higher price that private equity firms have achieved listing companies versus trade

Chart 6: Median EBITDA Multiple Paid in EU Lower Mid-Cap Deals



Source: Argos Mid-Market Index / Epsilon Research, 2014 sales is one of "the biggest changes" Stjernholm at IK Investment Partners has witnessed over the last few years. "They have done extremely well going down the IPO route," she says, while mentioning Sanitech in Sweden, as well as ISS and OW Bunker in Denmark. The owners of Recipharm, a specialty pharma company in Sweden, Stjernholm mentions, "tried to sell the company but ended up getting a much higher price on the stock exchange."

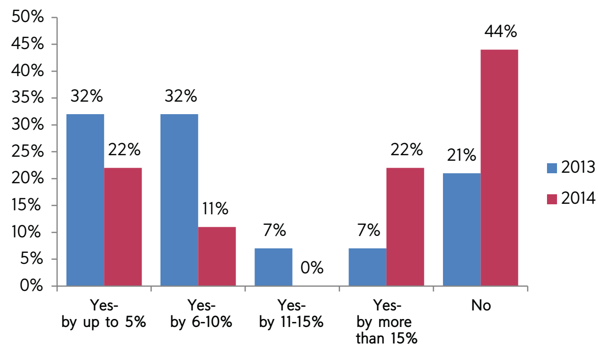
It is generally recognized that exits are good, and it is easier to sell at the moment than it is to buy because of weak deal flow. In addition to going public and selling to trade buyers, private equity firms are increasingly selling to other buyout firms and to some of the bigger investors who have created direct investment arms.

According to Bjørnøy at Norvestor, "There is a lot of talk of too much capital coming into the Nordics because it was seen as a safe haven after the financial crisis." Having started 15 years ago, he says the buyout market in Norway is fairly new, but it has attracted more and more foreign GPs. Bjørnøy notes that the larger deal size is where competition has become particularly intense, but he tells his LPs that more competition for the larger deal size is "beneficial for an investor because we have more people to sell to."

More competition means more work to find good deals. Bjørnøy observes that he is also seeing more competition in Sweden. Norvestor recently purchased Nomor AB, a Swedish company that he says, "We had followed for almost four years before we made the investment." Auctions are very competitive.

After years of consistent performance as a leading region for private equity, the Nordics of late have experienced a sluggish deal flow hit by concerns over the broader economic environment, as well as uncertainties over the regulatory climate. A recent survey found that 44 percent of GPs and LPs do not anticipate Nordic investments to outperform European ones this year—a significant rise from the more than 20 percent reported in 2013 (See Chart 7).[9]

Chart 7: Do You Expect Nordic Investments to Outperform European Ones This Year?



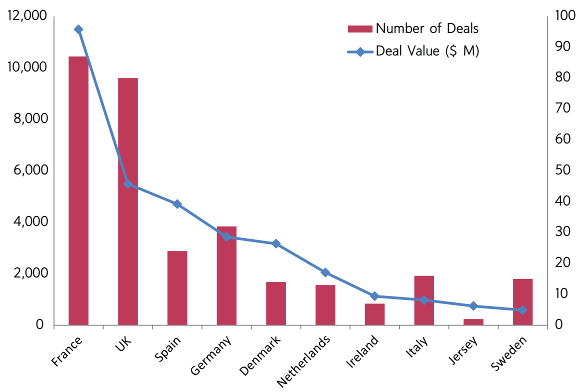
Source: unquote, Nordic Survey 2014, Incisive Media, 2014, p. 5

Some GPs are concerned that the memory of the market is short and that, like the last boom in the market, today's excess of liquidity is driving the wrong behaviour as multiples go up. Muñoz at MCH Private Equity says, "We haven't seen it yet in Spain, but I'm starting to hear that in other places in Europe, people are starting to get concerned."

Though the bigger buyout houses, such as KKR and Cinven, are opening up offices in Spain, the country's economic recovery remains in its infancy. In 2013, leveraged buyout activity in Spain totaled 2.8 billion euros ($3.8 billion) according to Thomson Reuters data, half that of the 5.6 billion euros in

2007—a peak year.[10] France held the number-one position for value of deals for first half of 2014, followed by the UK and Spain (See Chart 8).[11]

Chart 8: Top European Countries for Private Equity Deals in First Half of 2014



Source: Dealogic, 2014

As the fastest-growing economy in Europe, Poland has attracted growing private equity investment relative to countries with similar per capita GDP.[12] Where other countries have been slow to structurally reform their economies, Poland did so early, which earned it European Union membership and investor interest.

Exit Market Heats Up

As "full prices are being paid" in today's market, Barber at Bridgepoint believes, "It is better to be on the selling side of the trade than the buying at the moment." Moreover, it pays to think in "a very contrarian way about unloved countries and unloved assets." He mentions that "We're very pro-France at the moment where wonderful export-oriented businesses can be found."

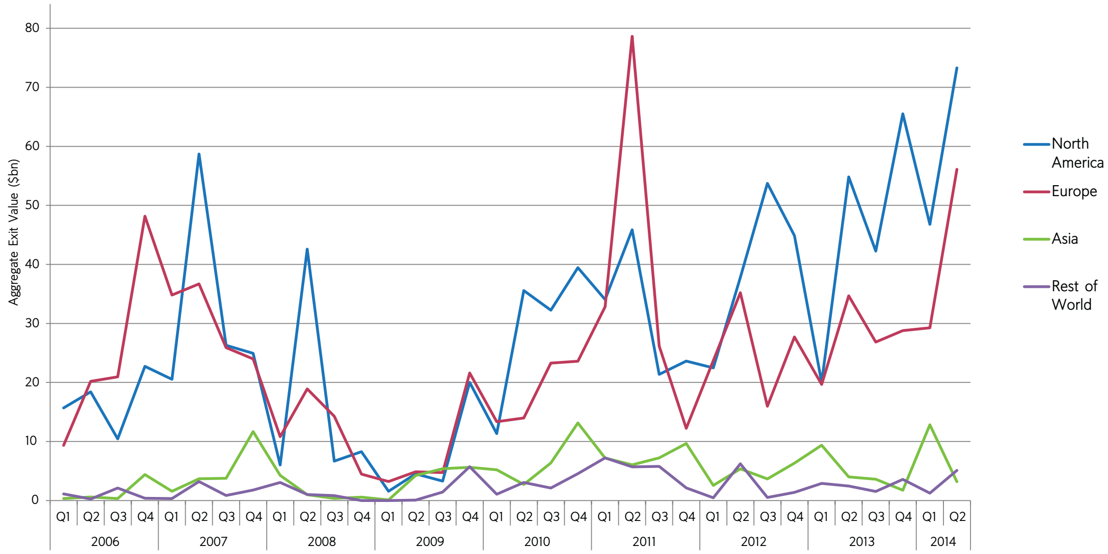
Barber says he often gets challenged by American investors about the fact that 25 percent of Bridgepoint's current fund is invested in French-headquartered businesses. Yet, he adds, it "is a disproportionately strongly performing part of our portfolio." At the end of day, "If we were at even fuller prices than the market offers today, I think that we could still find value, but we'd just have to work harder, think harder," he emphasises.

Like the U.S., which it trails in exits, Europe has seen a big uptick in exit activity since the start of 2013, driven by stronger equity markets (See Chart 9).

The "return of the strategic trade buyers, as acquirors—many of whom have high levels of cash after a relentless focus on leanness and cash generation," is fundamentally why Barber believes markets are toppier. The flip side of their buying activity is likely to be selling activity, now that they will not potentially be embarrassed by selling at the wrong time—as a result of the defensive position corporations were in over the three to four years after the crisis. He says, "There has been an absence of the normal flow of corporate rationalisation sales, corporate conglomerates, portfolio rationalisation, strategic moves and sell-offs of non-core divisions." In Bridgepoint's view, he says, "There is a huge catch-up flow of that corporate rationalisation deal flow still to happen" that will help bring the supply of and demand for deals back into balance over the next year or two.

Stjernholm adds that the situation today is very different compared to what happened after the crisis around 2000, where "we had a long period where prices were lower and multiples were very decent." This time around, she says, "After the crisis, very few deals happened, in 2009–2010. But now the deal pace has picked up, and many of the ones that have happened

Chart 9: Aggregate Value of Private Equity-Backed Exits by Region, Q1 2006 – Q2 2014



Source: Preqin, Private Equity Spotlight, July 2014, p. 13

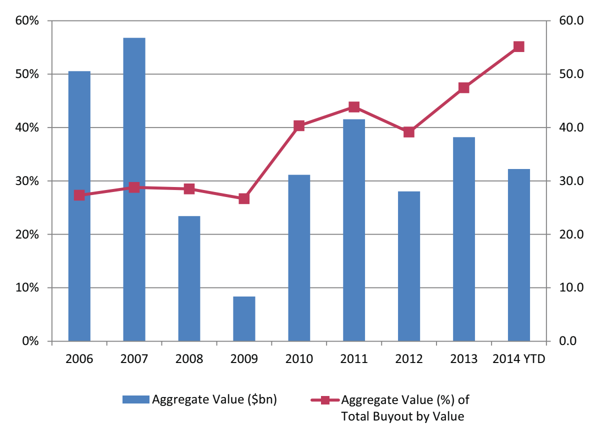
have had high prices." She points to two other factors—dry powder and, in the low interest rate environment, the universal quest for yield. This forceful combination "puts some pressure on the number of targets available for the PE funds."

In Central Europe, "increasingly the strategics are local," which Watson at Value4Capital sees as an exciting trend. "You sell a Polish asset to a Pole and that is just easier," he notes. The Warsaw Stock Exchange, he says, "has been one of Europe's more active IPO markets at different times over the years." Watson feels that because "that IPO activity does come and go" for mid-market companies, you need to "have a clearly strategic buyer-oriented exit strategy."

Secondary Buyouts Power On

Secondary buyouts are increasingly playing a big role in the lower and middle markets as fund managers look to build stronger, more international platform companies and become specialised at adding value to portfolio companies. They also add a key exit channel. As indicated in Chart 10, while their aggregate value in Europe has rebounded to virtually the last peak, they now represent more than half of the buyouts by value.

Chart 10: Aggregate Value of Secondary Buyouts and Percentage of All Buyout Deals in Europe, 2006–2014 YTD



Source: Preqin, 2014

"Over 10 years ago, we did almost none, and today, we have done quite a few," says Stjernholm at IK Investment Partners. The frequency seems to vary from country to country. In Sweden, "IK have done only two secondaries out of 28 deals," but in France, "it's quite a few secondary, even tertiary buyouts." When asked, "How can you do secondary buyouts—the potential must be gone?" Stjernholm responds, "Actually, if you buy a listed company, you could say it is also a secondary or tertiary."

For a middle-market GP, the typical secondary transaction is to sell a portfolio company to a much larger fund. Stjernholm notes that: "For example, Apax can in some cases take a company to another dimension than we can." When IK buys from other PE firms, it is typically "from smaller local firms who often are present only in Sweden or the Nordics, whereas with our European organisation, we can support the company in the next phase of growth."

Sposito at Clessidra is now seeing "some of the big names reappearing" in Italy, as they are trying "to get exposure to southern Europe. The reality is that most of them cannot compete on our deals." The deal environment is too complex—"Nondomestic suitors don't speak the language, don't have the local network, and don't understand our corporate governance," Sposito explains.

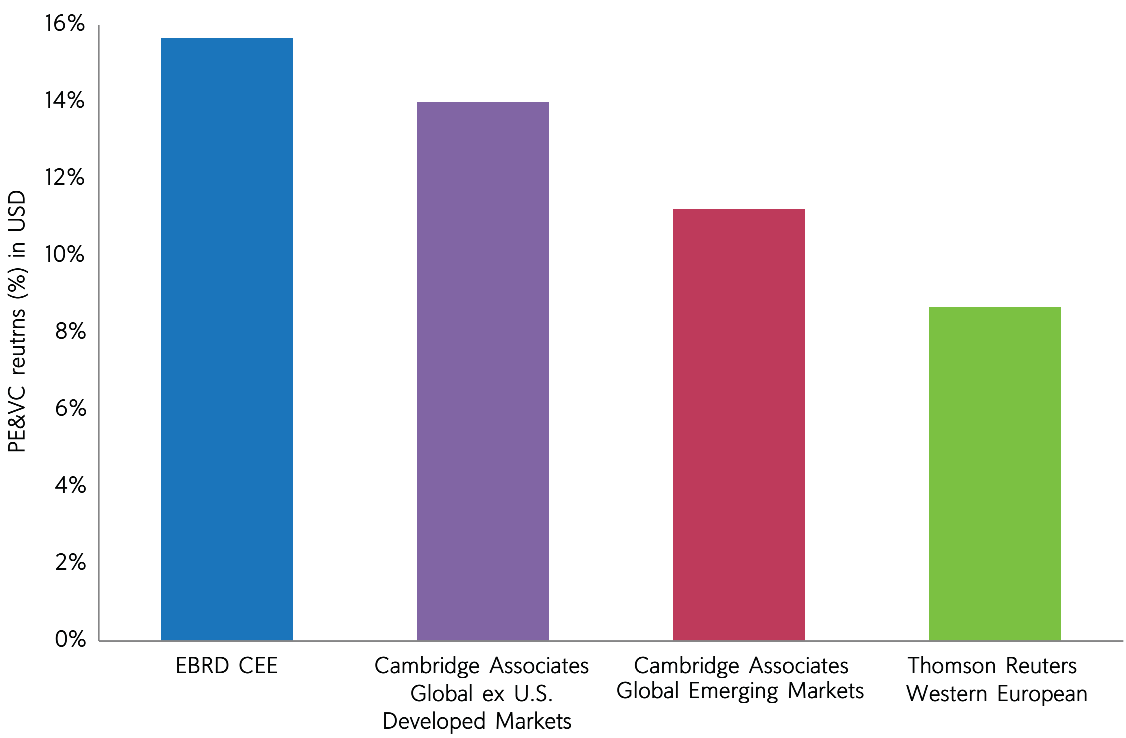
"It's really too difficult for someone who has an investment committee in Dallas or in China to be able to complete a deal," he says. Clessidra's big role is to "simplify governance for the next buyer." One example is Pirelli, Europe's third-largest tiremaker. "In less than a year's time as a shareholder there, we cancelled three shareholders' agreements, we took private one of the holding companies, and we have started merging three of them." Sposito continues, "We made the company contestable in the market by simplifying company control and introducing market-friendly governance." As a result, the company's stock has been re-rated and started attracting interest from potential buyers. Clessidra eventually sold its interest to Rosneft at a significant profit, he concludes.

HgCapital "is happy to sell to other private equity firms," says Donaldson, who goes on to note that "one of the beauties of the mid-market is that these businesses are large enough to float, but they are also the right size to sell to private equity firms or trade buyers."

Norvestor has "made 53 platform investments since 1993 and less than a handful of them were bought from other financial owners," says Bjørnøy. "In some cases, it is consolidation," he says, "but it is more about finding attractive growth opportunities to add complementary businesses to."

Focused on dealmaking in Central Europe, a less developed market, Watson at Value4Capital likes

Chart 11: Comparison of 10-Year Hozizon Net Returns (2011)



Source: Time for Another Look: Central & Eastern European Private Equity 2013, p. 9

to highlight that investors in Central and Eastern Europe (CEE) private equity funds "are able to access new and developing opportunities that are ripe for first-time private equity ownership."

Watson points out that secondary deals in Central Europe comprise a very small portion of the deal flow compared to Western Europe. He notes, "Over 58 percent of the deals of Central European private equity firms are purchases from the original business founders; 93 percent of deals in the survey were primary transactions buying directly from the business owners, rather than financial sellers." Sales between private equity firms and CEE were limited to only 7 percent of the total deals done.

Although focused primarily on first-time buyouts, Riverside has experience with secondary buyouts globally. As Langer sees it, these transactions are driven both by the "need for a liquidity event" and "each private equity fund typically has different skills that it can contribute to the company and therefore allows the company to move to the next stage of its development." He identifies Arena, an Italian swimwear business, as a good example. "We were the third or even the fourth private equity owner, and where previous owners had professionalised the business, the management and operations—and achieved good results doing so—Riverside made a big effort to internationalise it." Riverside "took Arena into the U.S. markets, which has launched it on a new growth path."

Arena's success "probably would not have happened if it had remained in the hands of the same investor for 12 years or more," says Langer. He underscores that "The fact that you have new people coming in looking at it with new eyes and wanting to achieve something keeps the management and the business on its toes." Arena was sold to Capvis, the Swiss private equity manager. As Langer sees it, multiple PE owners become another form of institutional ownership that is different from the stock market, "but it is a market that is institutional and that does have a liquidity event every three, four or five years. I think that is another form of institutional ownership, which is pretty healthy for a small company," he concludes.

Finally, secondary buyouts have gone one step further, with an increasing number of buyout groups buying back companies they had previously owned. In part, this trend is driven by heightened competition for assets, but buyers also gain a sense of comfort investing in businesses where they know the assets and management teams. Montagu recently re-purchased Open International, which it sold eight years ago, and Duke Street joined with Partners Group to purchase Voyage Care, which it had sold to HgCapital in 2006.[13]

Concerns, Challenges and Risks

A tough deal environment raises challenges. A rough consensus among GPs is that the big issue in Europe is not financing, but deal flow. This is a function of both increased competition in the middle market, as larger players have moved into the space, many of them U.S. players; and that competition is coming from certain pension funds, which are going direct.

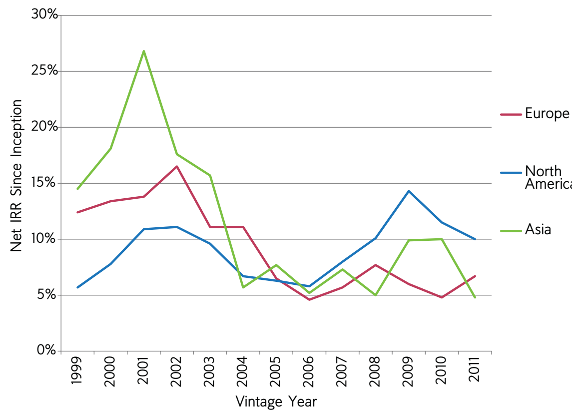
A more mature market also means more sophisticated sellers. "Today, there are very few owners or boards of directors who are comfortable selling a business without checking with more than one party to make sure that you get the right price," notes Stjernholm. "In several of the more mature markets in Europe, it's rare that you don't have any competition at all," she adds.

A big concern for Donaldson at HgCapital is the growing risk that comes from "being substantially outbid by people with little sector experience, giving weak management agreements, using a lot of leverage and paying historically high multiples." He also thinks that "Sector expertise is one of the most overused and loosely defined approaches to private equity." Donaldson is concerned that "the generalist investors are now participating further down the continuum of sector specialisation in terms of doing deals, without the same level of knowledge of the people who they're competing with, which is creating higher-than-normal prices in some sub-sectors."

Is there a danger that rising prices and the hot exit market will enable owners to sell companies for much more than they are worth? Muñoz at MCH Private Equity believes "asset quality today is a most important challenge." Yet Fendel at Quadriga sees "deal supply" as "the big challenge of our regional markets." He continues, "too much money chasing too few deal opportunities," is a challenge that we have seen for many years. Finally, Donaldson at HgCapital fears that the frothy market "brings a risk that we get into too much of a transactional mentality rather than an investment mentality," with the associated risks "that we do things too fast with not enough time for sound diligence, and we overpay for lower-grade assets."

As a result of both the depressed economic environment and intensely competitive market, the returns achieved by recent vintage-year European-focused funds have not been stellar (See Chart 12). A key missing driver has been economic growth across the market.

Chart 12: Median Net IRRs by Vintage Year and Geographic Fund Focus



Source: Preqin, Quarterly Private Equity Update, Q1 2014, p. 10

Family Offices – Respected Investors but Not Meaningful Competitors

GPs tend to have a high level of respect for family offices, both as fund investors and direct investors, but they have had little interaction with them in the deal market. They appear to have been more prevalent right after the crisis when more entrepreneurial, long-term capital that family offices represented filled the funding gap left as institutional money rebalanced its portfolios. In some countries such as Spain, "They were never really an essential player," notes Muñoz of MCH Private Equity.

In the view of Langer at Riverside, family offices are "smart investors" and "are useful components to have in the market." He observes, "When they invest as direct investors, they put money to work in areas where they have original founder or entrepreneur expertise, and so they are quite savvy." This means, Langer continues, that "they can be quite good co-investors." In the end, "A well-run family office is a great way for an entrepreneur or an entrepreneur's family to invest some of their money in companies where they can really make a difference."

One key financial statistic suggests that family offices and wealthy entrepreneurs are becoming PE rivals—whether or not they are noticed. The value of leveraged acquisition loans taken out by entrepreneurs and companies in European currencies rose to €6.97 billion ($9.54 billion), more than the €5.58 billion of such loans arranged for buyout firms, according to S&P Capital IQ LCD.[14]

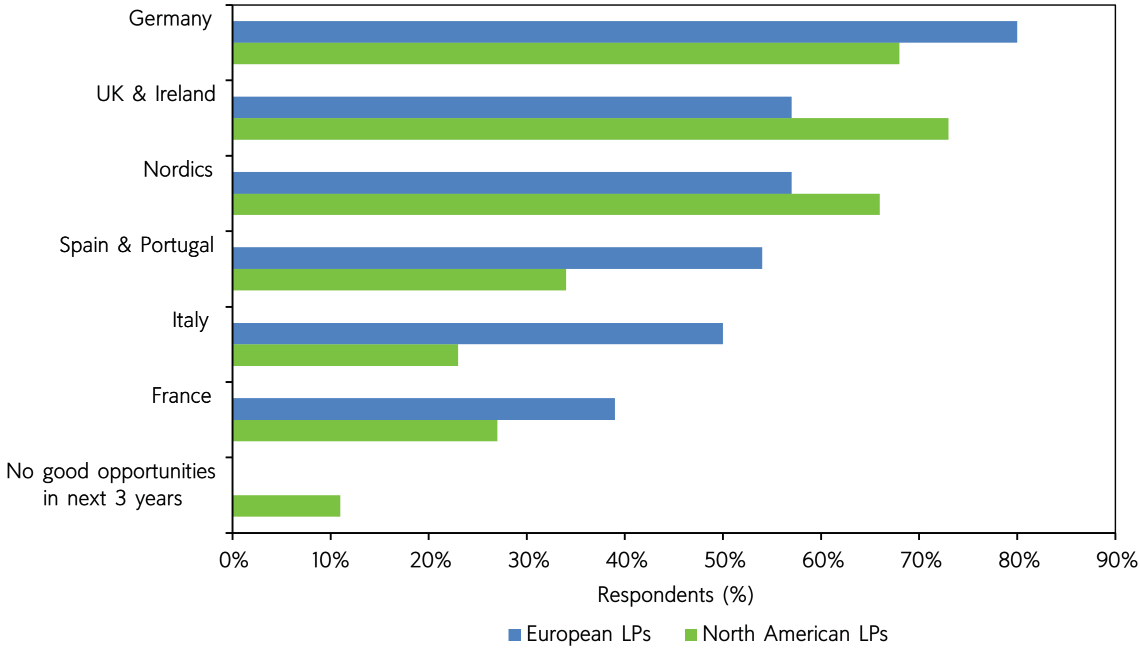
Among the entrepreneurs taking advantage of cheap debt finance to do deals themselves are the French billionaire Patrick Drahi, with a $23.5 billion takeover of Vivendi SA's mobile-phone unit SFR; U.S. investor John Malone's $10.8 billion purchase of Dutch cable company Ziggo; and Germany's billionaire Reimann family's $10 billion of leveraged finance to combine the Dutch maker of Douwe Egberts coffee with the coffee business of Mondelez International.

"Will they steal the lunch of the private-equity firms? No, but they will certainly be a meaningful competitor in some situations," said Alasdair Warren at Goldman Sachs. One big advantage is investment horizon. According to Bart Becht, who chairs Germany's Reimann family investment company, "We're not really looking to sell out of businesses. Our time horizon can be anywhere from 10 years to—there is no maximum."

OUTLOOK–*Where and What Are the Opportunities?*

Middle-market GPs are cognizant of the varying dynamics across Europe in terms of the level of competitiveness and intermediation, and they tend to see a rich diversity of opportunities; however, LPs tend to generalise. Thus, the latest Coller Capital Barometer found the majority of the world's PE investors are considerably more upbeat about the opportunities to invest in Northern Europe versus Southern Europe (See Chart 13). North American LPs are particularly sensitive about investing Southern Europe, with less than one-third seeing good PE opportunities in Iberia, Italy or France in the next three years.[15]

Chart 13: Location of Attractive PE Investment Opportunities in Europe in the Next Three Years



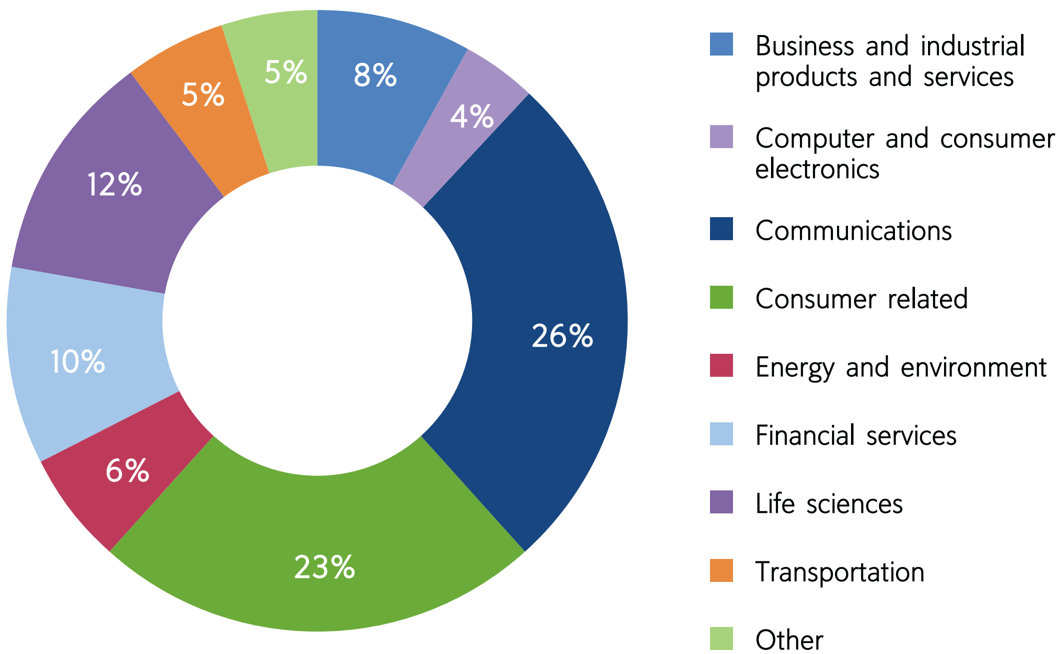
Source: Coller Capital, Global Private Equity Barometer, p. 8

Fendel at Quadriga says that "Given the size of our [German] market, we need an opportunistic approach to see all of the opportunities which are there." Like other GPs, Quadriga "has many industries in which we have built up an in-depth industrial knowledge, such as the machinery industry, industrial automation service and the healthcare industry," he explains. Fendel sees opportunity in operating healthcare firms, especially "in a country where the state-owned companies still have a significantly high market share of 70 to 80 percent while generating significant losses," which to him, suggests that "private operators have a strong chance to support the market transformation."

"We call it 'Made in Italy' for the global markets," according to Sposito, who frames Clessidra's strategy of leveraging "companies that have developed a specific competitive advantage, be it technological or style, and have market leadership in the specific niche." The focus is on "specific segments of the pharmaceutical and chemical sectors, furniture and design, and specialty food" that includes "companies feeling the pressure of globalisation and consolidation." These "fragmented segments of the Italian economy are where there are obvious benefits and synergies," notes Sposito. "We can play a significant role identifying the segment champion, and help them to consolidate a more meaningful market position in the global arena," he says.

In Central Europe, Watson thinks the continued dynamic will be "ownership succession," where his group teams up with "founders at an inflection

Chart 14: Aggregate Sectorial Amounts Invested in Central and Eastern Europe



Source: Time for Another Look: Central & Eastern Europe Private Equity 2013, EVCA/PEREP_Analytics, p. 20

point for the business where owners want to exit or take some liquidity, and the entity is in the process of moving from being an owner-managed business into a real company." He says, "One of the positives to come out of the financial crisis for Value4Capital is an increased willingness and realism among owners about selling their businesses and the benefits of having a strong private equity firm as a partner."

Riverside's focus is "on European companies that have strong technologies, strong brands and strong know-how, which they are able to sell outside of their own borders," explains Langer. The key is not to become dependent on the performance of any one domestic market. He believes that Europe "is still fragmented in many ways" but that "there are plenty of entrepreneurs with business models and ambitions that can be helped to achieve international success."

"I think you can make money across a whole range of sectors," explains Watson, "if you have the strategy and the expertise and, ultimately, the opportunity—someone to actually sell you a business in that sector." In Central Europe, Value4Capital is "very bullish on the services market," as he sees the "potential for growth in a number of mid-market-sized companies that service the broader European production industry." Accounting for 8 percent of total private equity capital invested, the business and industrial products and services sector has room to grow (See Chart 14).

Drivers for Creating Value—Operational Improvements and Add-ons

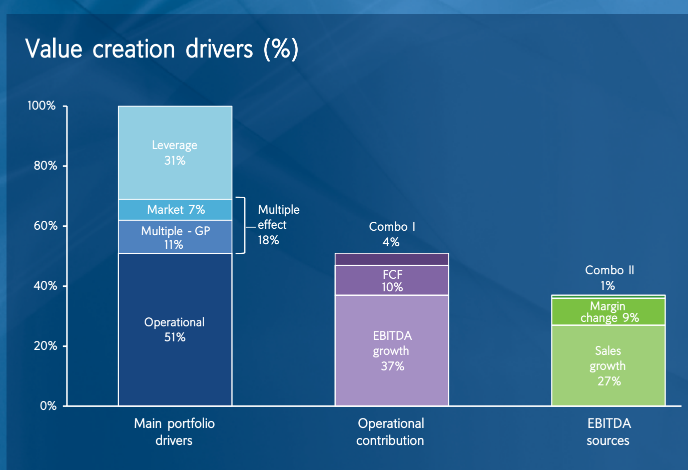
"In a slow- or no-growth environment, a huge part of our investment process is focused on sectors, spaces, niches which offer substantially above-trend growth," is how Barber described Bridgepoint's strategy for creating value. He notes, "We have a research-driven approach that identifies these kinds of interesting spaces—ones where we think we can make an impact and partner with management in expanding businesses, doing add-ons and pursuing consolidation plays and operational improvements/business efficiencies." Ultimately, in private equity, Barber says, "You best make your own luck through positive investment in business growth."

NEW STUDY FINDS OPERATIONALLY-DRIVEN VALUE CREATION TO BE ASSET CLASS' KEY SOURCE OF ALPHA

Following up their 2009 inaugural research study on the determinants of value creation for deals made at the peak of the buyout boom from 2005–2008, Capital Dynamics and the Technische Universität München recently analyzed additional data from more than 700 global exits completed between 1990–2013.

As highlighted in the chart below, operational contributions accounted for roughly half of overall value creation, while the use of leverage accounted for just over 30 percent of total value creation and the multiple effect for 18 percent. (Uplift in public market valuation contributed 7 percent of this; while the majority, 11 percent, was due to private equity deal-specific multiple expansion.) Above market multiple expansion was linked with qualitative operational improvements, such as GPs' ability to improve asset quality by gaining market share, institutionalisation, brand creation and diversification of customer base.

The study found that a noticeable shift occurred in the sources of value creation in 2005–2008 deals, as leverage contribution diminished and operational factors, such as EBITDA growth, became the major drivers of successful value creation. Regionally, European deals generated more value from free cash flow (FCF) and multiple effect, while North American deals saw higher value creation from the increase in EBITDA due to sales growth.



Source: Capital Dynamics, Value Creation in Private Equity, Joint Research Findings from Capital Dynamics and the Technische Universität München, June 2014

In the view of Sposito at Clessidra, "We are always using a hands-on approach," and he emphasises that "most of the value creation comes from operational efficiency and improvement, also thanks to our four operating partners." He stresses, "The key for a successful investment continues to be the ability to attract the right people, the right talents to introduce in companies." For Sposito, "The key is making the company more efficient and better managed; this is how you create value."

Particularly for the lower and middle markets, GPs are in agreement that the predominant focus is on management, governance, reporting and operational improvements. Unlike the bigger global buyout firms, the smaller groups often do not have the luxury of full-time operating partners on payroll.

"We do not have a single strategy—we're opportunists," says Stjernholm at IK Investment Partners. She mentions that "Sometimes the opportunity is to enter a new market or develop a new product. Sometimes it's more of an operational improvement case." Ultimately, Stjernholm notes, "It's very deal-specific." According to her, "One of the challenges in Europe is to find the growth."

"Most of Norvestor's value creation comes from increased EBITDA," notes Bjørnøy, "generated from operational improvements, combined with both acquisitive and organic growth." He continues, "For us, it is not so much fine-tuning the operations, but about assisting the companies in managing growth." As a result of the significant growth prospects—"companies grow by 3 to 5 times in revenue during our ownership"—Bjørnøy indicates that when Norvestor sells the company, "it can have a very different organisational structure."

Muñoz at MCH Private Equity points out that they "are also looking at situations which can lead to a more pan-European profile and, thus, where you need to "do something more substantial than writing off debt, or debt-for-equity swaps." In this sense, he says, "Private equity can play a substantial role in the economy in terms of either making possible balance sheet restructuring and/or injecting funds in some cases to strengthen a firm's capital structure."

Growing competition among PE firms is generating more sophisticated approaches to assessing company risk and proactive approaches to transforming businesses. Fendel at Quadriga says, "Today we have to act like an industrialist, we have to fully understand the business and how we can change this business." Earlier, he notes, "Management was always the most important topic a company would have when you bought it, but today, we are focusing on a company's strategic potential and decide then which management skills are required to materialize it." In Fendel's view, "The ones who are successful have an institutionalised investment process with very high discipline." Put another way, he says, "You have to scale skills and methodologies to support the portfolio companies' avoiding failures and generating value."

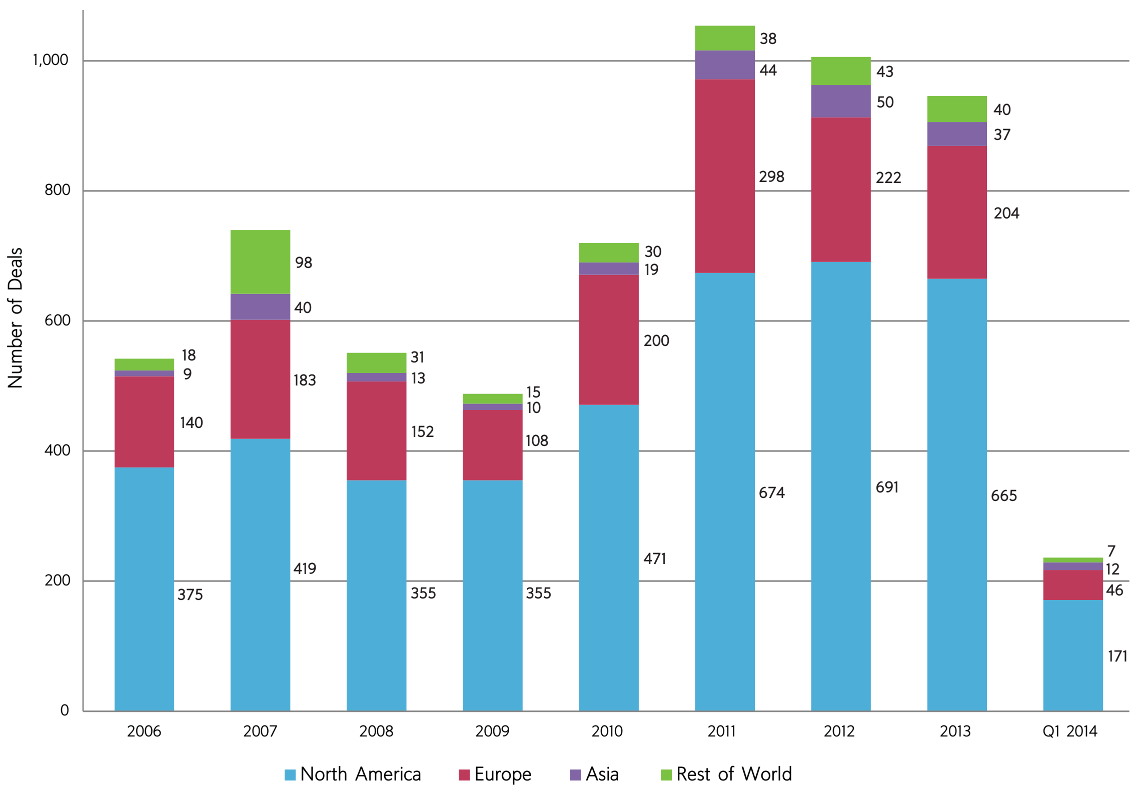
Add-ons and Platforms

Add-ons are a big part of the middle-market PE firm's value creation tool kit. At Bridgepoint, Barber mentions that "We have done 85 add-ons in the last four years, in 22 businesses, of which 12 have had add-on oriented strategies." He goes on to note that Bridgepoint has "a big French property management services business that has done 30 add-ons." Barber believes, "In the future, there will probably be more value creation from revenue effects because we are much more focused on taking really good European businesses to global markets than we were 10 years ago." To that end, Bridgepoint recently opened a Shanghai support office that does not do investments, but is focused on providing access to Asian markets.

As indicated in Chart 15, add-ons have been growing across all the regions and are a particularly important strategy to quickly gain scale at the lower and mid-markets.

Quadriga and Norvestor are two other big believers in add-ons. "I would say if you take our acquisitions, 30 percent are platforms and the other 70 percent are add-ons," observes Fendel at Quadriga. "We have made 53 platform investments since 1993 and almost 200 add-ons," says Bjørnøy at Norvestor. In some cases, he mentions, "It is for consolidation, but it is more about finding attractive growth opportunities to add complementary businesses." Operating in the lower mid-market is about building businesses, and add-ons are a proven tool.

Chart 15: Number of Private Equity-Backed Add-on Deals by Region, 2006–Q1 2014



Source: Preqin, Private Equity Spotlight, April 2014, p. 16

Scale, Pan-European and Specialisation

Middle-market GPs in Europe, for the most part, stand out for their local presence and hands-on management and investment style. Watson at Value4Capital believes, "You do need a local presence, especially in the mid-market where the companies are less sophisticated and local issues have more impact when not diversified across markets. It is hard to be that close to the micro from a central office." He says that deals at the regional level offer attractive returns, "not only because numerically, smaller companies are in bigger supply, but also because the demand is lower as there is often a narrower field of competitors that can execute them."

Fendel at Germany's Quadriga echoes the sentiment, saying, "A strong focus on markets with in-depth knowledge and cultural affinity drives the investment policy." He notes that Quadriga is "convinced that you need a very strong local contact in order to really understand what is going on there." Looking at the international, pan-European firms, Fendel says, "Most of them have either their local people on the ground or they do it with a local partner on a fly-in basis."

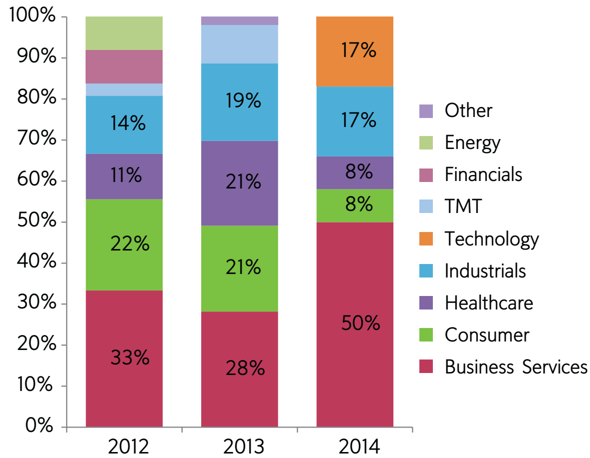
Some GPs view the diverse cultures of Europe as a barrier to scaling the private equity business, which means industry specialisation is challenging. "Maybe you could do it in a country like Germany—at least in some industries like engineering," observes Stjernholm at IK Investment Partners, "but most of the markets are so small and they still have different languages and currencies." She recounts the experience gained owning a construction company where even though the houses looked very similar in the four Nordic countries, what you are allowed to do and the kind of components you can use are very different. "The synergies were quite small," she says, adding, "I don't think it will come to a lot of industry specialists in Europe."

In the view of Watson at Value4Capital, increasing scale has gone hand-in-hand with the industry's increasing professionalisation as twin levers to better create value with dedicated resources. "When you are a relatively small firm, by definition, you are a generalist," he observes. It is "When you start managing larger funds and have the fee base to support really operationally focused professionals, that you become specialised," Watson says. That said, "When you still have so many differences in regulation, local culture and the sophistication of the markets, specialisation has its limits."

Norvestor operates "out of relatively small markets," says Bjørnøy. In the oil service industry, the firm has built companies with a strong home base on the Norwegian continental shelf from which to expand globally to other oil service hubs. In another sector focus, engineering and industrial products, "Most of those companies do not even have sales in Norway but are focused on international niche markets," he observes. Conversely, consumer markets, business services and outsourcing "would typically be more exposed to the Nordic region," he notes.

Business services in the Nordic region have appeal to the broader private equity market, attracting the greatest interest from respondents to *unquote*'s 2014 survey (See Chart 16). The consumer and healthcare segments have fallen out of favor, with the latter likely to contract given increasing government and public scrutiny about private equity's participation in this politically sensitive sector.

Chart 16: Which Sector Do You Think Will Be Most Appealing to PE Funds in Nordic Region over the Next 12–24 Months?



Source: unquote, Nordic Survey 2014, Incisive Media, 2014, p. 6

Donaldson says that despite the industry's growth, HgCapital "has become more focused over the years," and today invests in fewer sectors and stages of private equity than it did in 2001. "We're not interested in scale for scale's sake," he emphasises. "We're very much an investor rather than an asset manager."

As an investor, "You want to use scale only in so much as it gives you the ability to staff and compensate effectively the optimal sized team to prosecute your strategy," he points out. In Donaldson's view, "Returns have been trending down and risk has been staying about the same," but the good news is that "asset allocations are going to continue to go up." The key takeaway for the industry, he concludes, is that "in order to drive returns, you need to be more skilled than you used to be."

THE STATE OF FUNDRAISING IN EUROPE

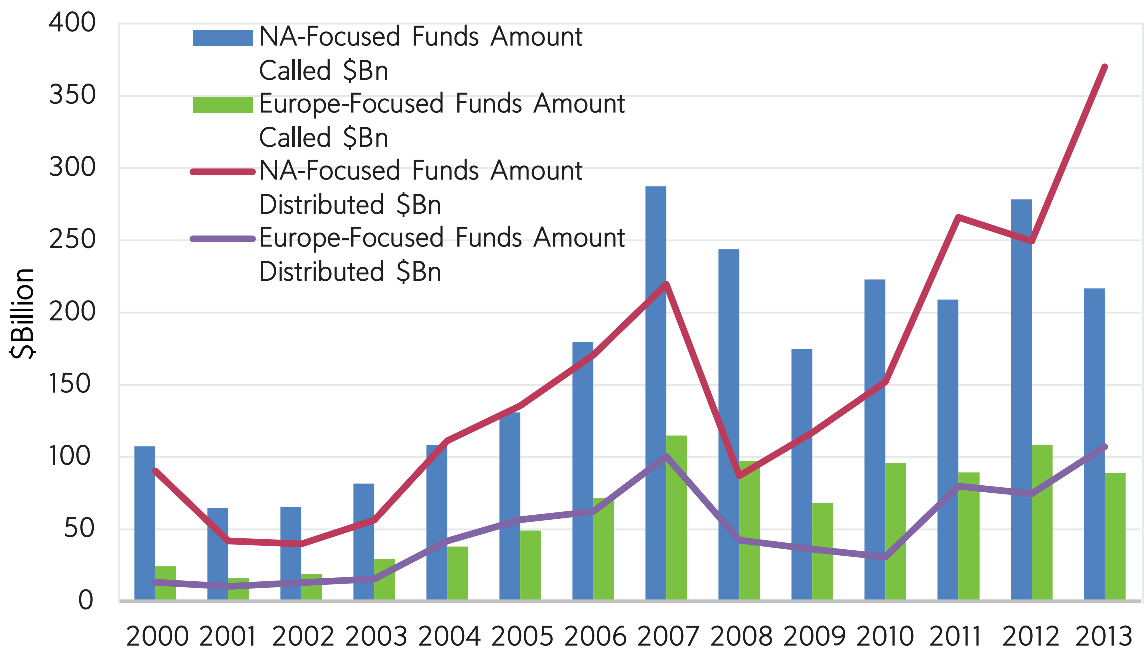
In late spring 2014, European middle-market GPs were in agreement that the fundraising market had improved, thanks to recovering economies on the continent and the relatively healthy U.S. and European equity markets—all of which have been instrumental in enabling investors globally to receive healthy distributions over the past year. Reflecting this relatively positive environment, as well as general attractiveness of lower- and middle-market funds, the GPs surveyed tended not to be under much pressure to change terms, although they agreed that LPs have more negotiating power.

A key contributor to the better fundraising environment is the fact that both Europe- and North America-focused funds returned investors more capital than called last year (See Chart 17). This was the second time in three years for North American funds and the first since 2005 for European funds. As indicated, the gap has widened between the amount distributed by North American versus European fund managers, which, in part, is due to the significant level of capital raised in 2007–2008 vintage year North American funds.

"There is nothing more powerful than cash back and real performance to take away investor concerns" about writing new checks to GPs, notes Barber at Bridgepoint. He explains that "The kind of demand that we are having is absolutely enhanced by the 26-percent equity market rise in the U.S. last year, and the 15-percent rise in equity markets in Europe." From an allocation point of view, "The private equity share of the pie has come down and people are underweight," Barber says. In addition to the general perception that "risk has receded," he believes, "American asset allocators are thinking their home market is expensive and they may be underweight in Europe."

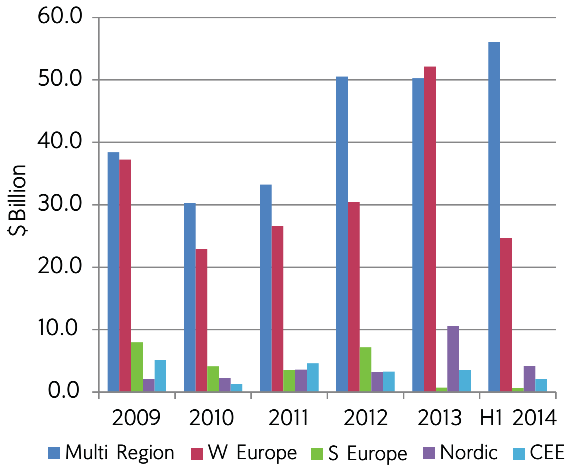
According to Preqin, private equity fundraising in Europe has increased year on year since 2010, with last year seeing more than $110 billion raised—a nearly 20-percent increase from 2012. Capital has been raised predominantly for multi-region funds, followed by those targeting Western Europe (See Chart 18). Nordic funds have been the next-most popular, followed by Central and Eastern Europe (CEE) and then Southern Europe.

Chart 17: Europe- and North America-Focused Funds—Called and Distributed Capital



Source: Preqin, 2014

Chart 18: Annual Europe-Focused Buyout Fundraising by Primary Regional Focus (All Buyout Funds)



Source: Preqin, 2014

Fundraising has not gotten easier, as Barber highlights that "The level of investor scrutiny and supervision is intense." He notes that Bridgepoint has "a [IR] team now of eight full-time people, four times more than five years ago. Everybody is still working 18 hours a day because of the immense volume of detail requested."

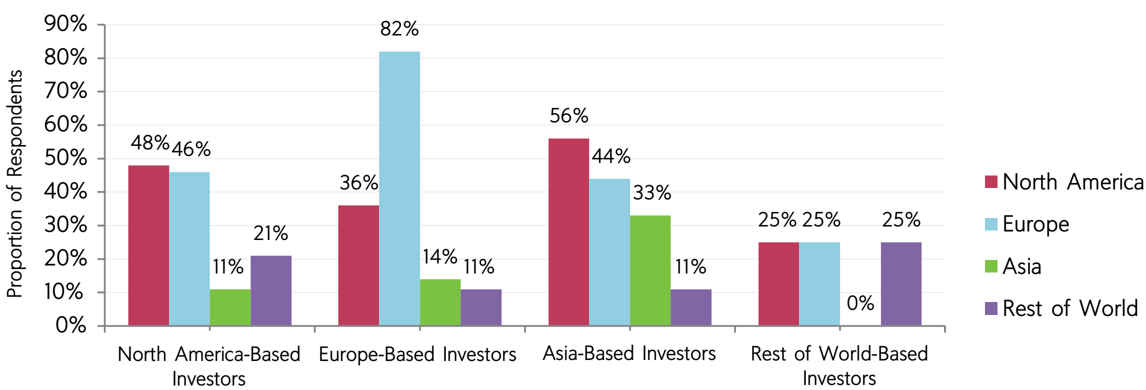
In conclusion, Barber says: "Is it a healed market vis-à-vis three or four years ago? Yes. Is there a positive sentiment in principle toward the performance potential of private equity? Yes. In practise, is it a highly discriminating market? Yes. Is it a punishing market for bad performance and behaviours, etc.? Yes. It is also a bifurcated, binary market: winners and losers."

Times have changed: In particular, places like Spain and Italy were furthest from investors' minds. "A year ago," mentions Donaldson at HgCapital, "nobody wanted to put money to work in Europe, and now it is red hot."

In terms of investor geographic preferences, North American private equity investors are almost split between their home market and Europe, whereas the vast majority of Europe's investors prefer the continent (See Chart 19). At the same time, while 65 percent of surveyed LPs based in North America made new commitments in H1 2014, only 56 percent of European LPs did so, reflecting uncertainties around both the economic and regulatory climate.[16]

Another sign that fundraising has bounced back is that private equity allocations are creeping up

Chart 19: Regions Found Attractive by Private Equity Investors



Source: Preqin Investor Outlook: Alternative Assets H2 2014, p. 13

again. According to Langer at Riverside, "This is logically driven by the very low interest rates and an expectation that we are entering an up cycle in which it is good to be invested in relatively long assets." More money is being poured into private equity by investors, but it is more selective than it was during the last cycle.

Stjernholm at IK Investment Partners says she sees "more pressure on right to co-invest rather than terms and conditions," which "is another sign of the intensified search for yields." But she clarifies that "It's a win-win, as the investors both get lower fees and they get to know us better. Thus, next time when we go into fundraising, the investors have a much better view of who we actually are and what we actually do with the companies the funds invest in."

The ability for different investors with different levels of skills and resources to take advantage of co-investment can raise "tension between investors, more so than between the GP and the LP," observes Stjernholm. Everything is getting more blurred. "ICG, who is a mezzanine provider in Europe, has started to do equity deals, so now they're competing with us," she notes. Stjernholm believes that "Investors want to concentrate, and make fewer but bigger bets." This presents a problem for mid-market

European funds like IK Investment Partners, as "There are some large investors whose minimum ticket is so big that it wouldn't be possible for us to have them in the fund, as they would be too large," she explains.

Although Norvestor has a general policy of offering co-investment to those who can act on the opportunity, "In the real world," says Bjørnøy, "we don't very often end up offering co-investments." In his view, "Not all the investors who want to make a co-investment are really set up to accommodate the process." Bjørnøy "feels no pressure on the fees," noting that Norvestor is "clearly within the 2 and 20 range with our fund size." This was validated in the "very large first close" the group had in December 2011 at NOK2 billion out of the NOK3 billion, that "included all of our Norwegian followers, which we had for all the three funds, and there were many large international investors that also came in, representing around two-thirds of the fund."

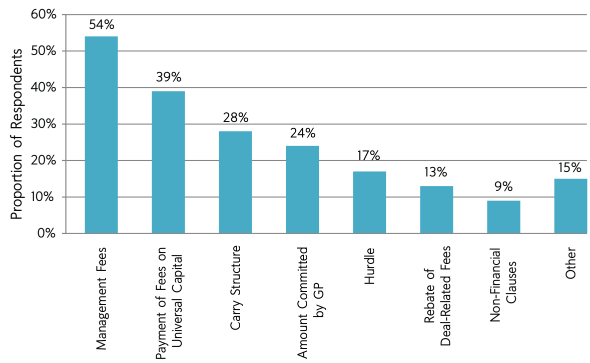
62% 

of investors made a commitment to a private equity fund during the first half of 2014.

Source: Preqin 2014

According to an investor sentiment survey by Preqin, the majority of investors in private equity believe that LP and GP interests are appropriately aligned, with more than 60 percent stating they either agree or strongly agree.[17] Regarding fund terms, management fees are identified by over 50 percent as an area that needs improving (See Chart 20). Moving up the list is payment of fees on un-invested capital, which garnered almost 40 percent of the investor vote for improvement, compared to just 6 percent in June 2013.

Chart 20: LPs' Views on Areas of Fund Terms and Conditions Where Alignment of Interests Can Be Improved



Source: Preqin Investor Outlook: Alternative Assets H2 2014, p. 15

Consistent with growing investor focus on un-invested capital, Bjørnøy has seen more investors calling for "documentation that makes sure we actually invest as much as possible of the total commitment." He says investors are pushing Norvestor "on the level where we can close the fund" and "the definition of what is invested and committed is much tighter." Bjørnøy adds, "Although they appreciate that we need to have some flexibility and some dry powder to follow up, they want to make sure that we actually invest the money that they pay a fee for."

From his vantage point in Spain, Muñoz at MCH Private Equity sees less money being raised, compared to the 2005 to 2008 period, and funds have reduced their target sizes, while some investors such as family offices and banks have "vanished." Consequently, "Next cycle will look better in that funds will invest faster and easier given less competition," he says. The process of natural selection will continue to work where "good funds will attract more money and the bad funds will have difficulties in attracting money, and there will be a consolidation in relationships."

Muñoz has not seen any big changes in investment terms. "There has been some discussion of whether the preferred rate really reflects the current situation for interest rates," he mentions. At 8 percent, it may seem high and "Some people are trying to push it back down to six." He adds, "This is a long-term asset class so you cannot just look at interest rates now." Muñoz indicates that the management fee discussion is "more relevant in very large funds" because of the large fee income they generate, whereas in the middle market, "We operate under much thinner margins." He believes that LPs are aware that if the return environment shrinks, GPs may "try to compensate for it a little bit."

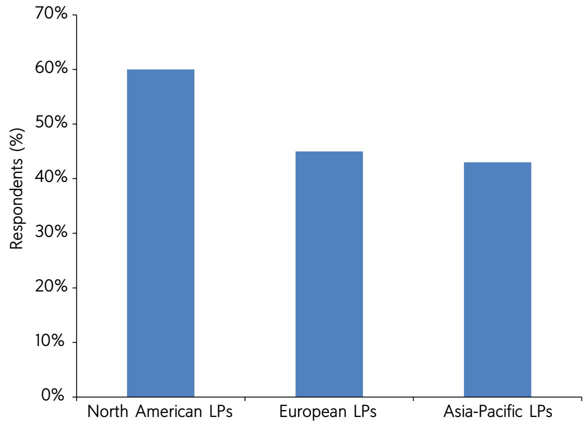
91% 

of investors plan to increase or maintain their private equity allocation in the longer term.

Source: Preqin 2014

Investors appear willing to lower the hurdle rate, but at a price. According to Coller Capital's latest Global Private Equity Barometer, 60 percent of the North America-surveyed investors and approximately 45 percent of the European investors would accept lower hurdle rates in return for lower fees (See Chart 21).

Chart 21: LPs Who Would, in Principle, Trade Lower Hurdle Rates for Lower Fees



Source: Coller Capital, Global Private Equity Barometer, Summer 2014, p. 4

One of the most important lower-middle-market fundraising issues at Value4Capital "is the increasing concentration of capital amongst LPs," which translates into "fewer and fewer investors who are able to engage in discussions about smaller funds and smaller commitments." This "is putting a squeeze on smaller funds (*e.g.*, sub 400 million euro) to find a broad investor base," Watson emphasises.

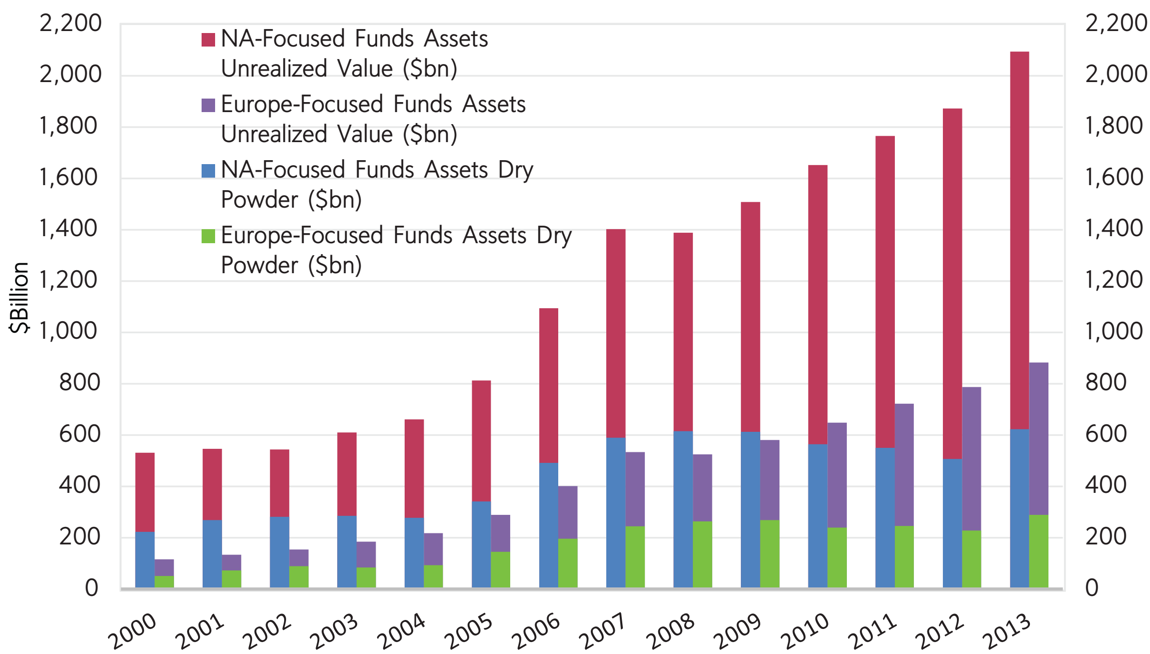
The problem is aggravated in Central Europe because of the dearth of local capital. The domestic investor base is extremely small. Watson says this means, "You have to sell to international investors that have never visited the market and that, by definition, is harder, particularly when the guys that are sophisticated enough to understand the story are too big to make the small commitments that your fund can digest." These dynamics "make the emergence of new managers very difficult and puts the importance of institutions like the European Bank for Reconstruction and Development and the European Investment Fund very much front and centre," he concludes.

Finally, another key area of consensus for GPs is their focus on continuing to expand their investor base beyond Europe. For Bjørnøy at Norvestor, this means looking increasingly to the U.S. and Asia. In some cases, there has been a notable change in the profile of investors. Fendel at Quadriga notes that insurance companies and some of the banks who used to be big private equity investors are having to step back, given tighter regulations around capital requirements.

Outlook—Cloudy with Heavy Dry Powder

Like North America, European investors have benefited from significant distributions and also face growing dry powder—reaching $288 billion in 2013—along with an increasing pool of unrealized assets valued at $594 billion (See Chart 22). While the value of the North American assets under management is nearly 2.5 times larger than Europe's, the concern for investors in funds targeting Europe is whether economic growth will return with sufficient momentum to put dry powder to work, as well as to stimulate the exiting of unrealized assets.

Chart 22: European and North American Assets Under Management



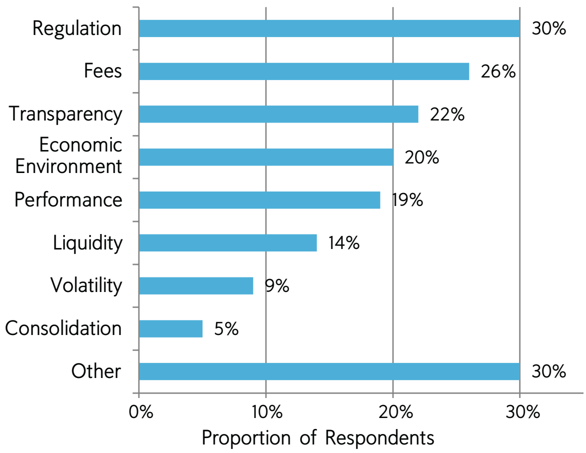
Source: Preqin, 2014

REGULATION AND PRIVATE EQUITY'S IMAGE—*Two Increasingly Linked Parts of the Business*

European mid-market GPs generally believe the recent onslaught of new regulations will raise the cost of doing business—but not fundamentally change how business is done. Opinions range—from being a "regulated asset class" is a good thing, to the belief that regulation is poorly justified, ineffectual, and will be particularly harmful to investors. GPs believe there is significant value to be gained in regulators better understanding what it is they are regulating.

Preqin's latest investor survey indicated that regulation is the leading challenge LPs face in operating in the industry (See Chart 23). Looking across the different alternative assets, the greatest percentage of investors (28 percent) felt regulatory changes for private equity were not beneficial in contrast to hedge funds, where the greatest percentage (47 percent) found that new regulations were beneficial.[18]

Chart 23: Biggest Challenges Facing Investors Seeking to Operate an Effective Private Equity Program at Present



Source: Preqin Investor Outlook: Alternative Assets H2 2014, p. 14

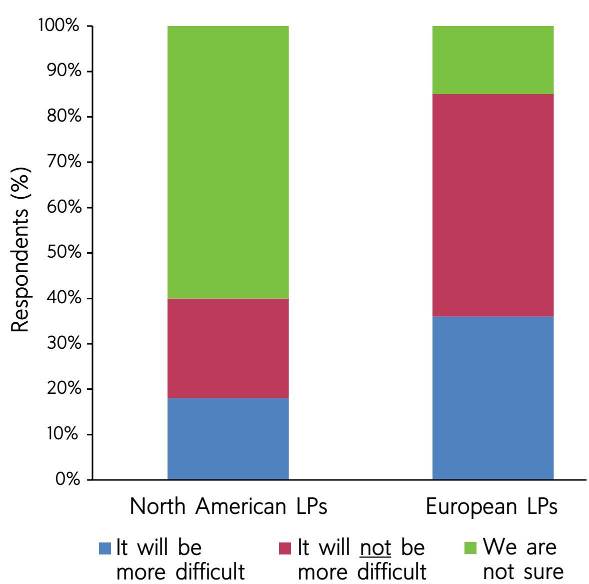
GPs tend to agree on the need for regulation, but also that it comes with a cost. Questions arise on whether regulation is directed at real problems that can be successfully addressed by government action. The significantly increased regulation around fundraising based on the perceived systemic risk that private equity raises is often held out as an example of why more education about the asset class is needed.

Fendel at Quadriga agrees that regulation's impact on fundraising is "definitely a huge impact." He says that "It is not only true for banks but also insurance companies," noting Solvency II requirements for further documentation add to the cost of doing business. "It has generated a large amount of legal fees," is how Langer at Riverside sees the impact of additional regulation. "At least for the larger firms, it is mostly a case of getting the formalities right, but does not really require fundamental changes to the operating model," he notes.

According to Stjernholm at IK Investment Partners, the Alternative Investment Fund Managers Directive (AIFMD) was "driven by a need for the politicians and regulatory decision makers to show that they were taking action after the financial crisis." However, its impact will be less on how private equity firms do business, but "more on the fund administration side and ensuring compliance with the directive."

Just over one-third of European investors surveyed for the recent Coller Capital Global Private Equity Barometer believe that the AIFMD will make it more challenging to invest in European PE funds, while around one-half do not believe their own operations will be impacted (See Chart 24). In North America, about 60 percent of investors are still uncertain about the directive's impact on investing in European funds.

Chart 24: LP Views on the Impact of the AIFM Directive on Investing in European PE Funds



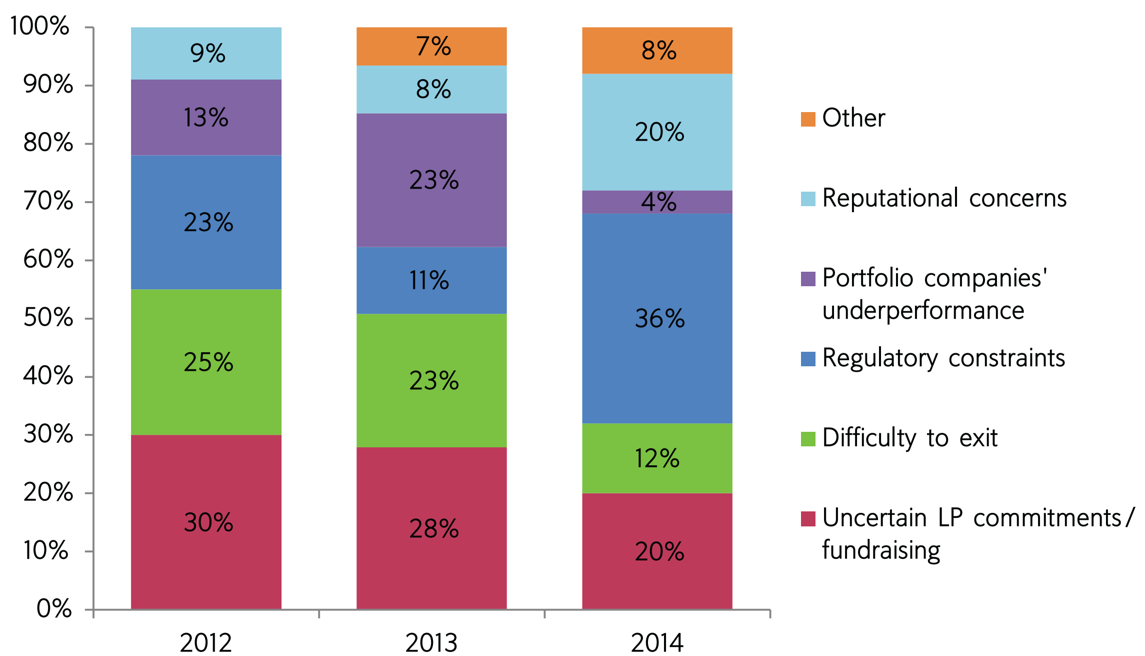
Source: Coller Capital, Global Private Equity Barometer, p. 4

Regulatory concerns have jumped to the top of list of the biggest issues facing private equity funds in the Nordic region. More than one-third of those surveyed in the region by *unquote* singled out regulatory constraints, up from just over 10 percent in 2013 (See Chart 25). In the same survey, more than half of those surveyed attributed the slowdown in Swedish deal flow and uptick in neighbouring countries to growing regulatory challenges in Sweden.

Watson at Value4Capital takes a more positive view, asserting that to be recognized as a regulated asset class "is a very strong positive statement. It tells the market we are serious, professional and responsible to someone other than ourselves." And in Italy, Sposito at Clessidra does not see any big changes. He indicates that his firm is registered in Italy and controlled by the Bank of Italy. "Italian regulations have always been stricter than the Europeans': For example, we already had higher capital requirements than ones being proposed," he explains.

"Regulation in and of itself is probably a good thing," says Donaldson at HgCapital, "but it's got to be a partnership rather than a wrestling match. It comes with a responsibility that the regulators understand the asset class and how the businesses work." Done properly, he emphasises, well-regulated businesses will "make money for the local economies, for the employees of the company, for the company, for the pensioners and the pension fund that invests in the GP and for Europe in general; and if it all goes well, it makes money for the GP, as well." That, he

Chart 25: What Is the Biggest Issue Facing Private Equity Funds?



Source: unquote, Nordic Survey 2014, Incisive Media, 2014 continues, "is a pretty remarkable good thing." Donaldson points out that "what governments want and what is good for Europe is very much aligned with what private equity firms want."

Image Is Getting Better – But More Work to Be Done

Outside of certain pockets such as Sweden and Italy, private equity's image in Europe is generally getting better. As the number of PE portfolio companies grows and more small family businesses become familiar with the asset class, both the public and some of the political establishment are starting to take notice. Its image has been bolstered by sticking with its companies when the economic climate was particularly challenging and sources of capital were scarce. But, as its profile is raised, the fund managers believe the industry may become an easier target, which suggests a growing role for public relations.

"Over the last 10 to 15 years, private equity has become a household name," explains Bjørnøy at Norvestor. Target companies, he says "are very much aware of the opportunities" and the value that more competition brings where we represent

EQT PARTNERS MANAGING PARTNER URGES INDUSTRY TO REFLECT ON BAD REPUTATION

The following are highlights from a speech by Thomas von Koch, managing partner of EQT Partners, at the European Private Equity and Venture Capital Association Symposium in Vienna on June 13, 2014.

"There is nowhere to hide in this connected world. We went from focusing on just one stakeholder—our investors—to becoming an integral part of society; it is time everyone in this industry acknowledges this responsibility."

"We should all reflect on why we have gained such a bad reputation, and our behavior is crucial—only by behaving in a transparent manner to all stakeholders will we regain trust."

"In order to keep our license to operate, we need to move from being purely investors to being owners that truly develop companies and their ... value for society as a whole. This model ... will transform private equity from an asset class to a respected ownership model."

"Private equity is here to provide good returns to the investors, but that's not enough. The way we create returns is equally important. By truly developing companies, by making them strong and sustainable for the future, value can be created for all stakeholders in society, not only for investors."

"Gender equality is a similar issue catching up on PE. The industry really lacks here and we have a long way to go, but opportunities are huge."

"It is 'adapt or die' now. The survivors in this challenging market environment will be the firms able to adapt—investors that do not accept their responsibility to do good will disappear. We have to transform ourselves in the same way that we transform the companies we invest in."

"The responsibility also lies with LPs and all the intermediaries in our profession."

an attractive exit, or "an interesting route for family-owned or founder-owned companies to develop their companies." As we "have not had any scandals," Bjørnøy thinks "the general perception is good."

Both he and Stjernholm at IK Investment Partners agree that the debate over taxes and PE in the Nordics has not helped its image. In Stjernholm's view, it is overshadowing the more important story about making companies more competitive and creating value for investors. Bjørnøy also says private equity's reputation in Sweden has been harmed, given "some difficult situations within the healthcare and ward [retirement] sectors" where there has been a push to prevent "private equity from being able to own hospitals, ward homes and even schools." That said, Bjørnøy believes the industry "is also viewed as a very large and important employer and factor in the dynamic business environment, so it is a more split view."

In Spain, Muñoz at MCH Private Equity "doesn't think there is a problem with the public perception of private equity" nor does he see media going out of their way to put the business in a bad light. Muñoz says, "There is awareness on the part of politicians that this is an industry that needs to be taken care of and nurtured." In his view, it is important to communicate three things that private equity provides to the economy:

- Its ability to strengthen the capital base of many companies;
- In the form of venture capital, private equity can contribute to new business formation; and
- Liquidity, enabling people to sell their business, and sometimes, enable companies to survive.

"In Central Europe, the image is very positive. We are more associated with investing real money into real businesses that grow and become successful, and that are not associated with layoffs and cost-cutting," Watson at Value4Capital points out. This is consistent, he says, with the region being the leader in economic growth in Europe, having an attractive cost base, and attracting foreign direct investment. And unlike frontier markets like Turkey, China or Russia, he adds, we "are integrated into the European economic system, which helps to reduce risk."

Langer at Riverside believes that over the last five years, "A lot has happened in our relationship with the political establishment, which has helped to present private equity as a regulated industry and one that they can work with." It is a good sign, he says, "When you start to see private equity being mentioned in the context of areas such as long-term investment and entrepreneurial driven growth." Though the industry exists "to make money for our investors," he says it is important to demonstrate that "We generate value in a responsible way and help to create a more competitive economy."

In Italy, Sposito at Clessidra thinks PE's image "has worsened" because people associate it with the financial institutions at the center of the crisis. Unfortunately, he says, "Everything which is financial has become evil," meaning "we still have a lot of work to do in terms of communication and perception." But what is often lost on media, politicians and the public is private equity's role in providing returns for long-term institutional investors. Watson at Value4Capital emphasises that the asset class has "always been oriented to building value for our investors, and our investors include pension funds, so we are building value for the people on the street."

"We are definitely not the best PR guys," says Fendel at Quadriga, but our "image has improved." He sees this perspective evolving primarily because "we have many more multipliers," for example, in terms of the number of employees now within private equity-financed companies. These multipliers support the industry's development and goodwill, he explains, "Given that a politician, who is responsible for a certain area with a larger set of companies which are private equity owned is much more aware of their relative importance." A key part of the story to Fendel is that private equity "has an ownership concept which harmonises interests." As a result, "operational and capital interests are merged," enabling it to better clean up inefficient organisations, improve operational performance and change company culture.

A challenge Donaldson at HgCapital sees is that "Private equity is a fairly varied industry—*e.g.*, the best performing fund and the worst performing fund could not be more different." He notes, "There are huge variances in performance, culture, approach, size, scope, scale, ambition and mentality." At the end of the day, Donaldson says private equity's case is clear and strong: "It outperforms all other asset classes when it is well-practised, and it does so across market cycles. It does so with longer-term capital, and it does so in a way that creates growth. Why wouldn't you want more of that in the industry and in Europe?"

CONCLUSION

The global financial meltdown that erupted six years ago and the European sovereign debt and banking crises that followed have left many of the Eurozone economies sputtering. Last spring, when equity markets were rising and the private equity market was looking "frothy," and before the world's second-largest economic bloc began to noticeably slip back, the GPs we interviewed did not see much, if any, economic growth on the horizon. Yet, they were busy in the engine room of the middle market doing deals and raising funds across the continent.

Thus, while they are unlikely to receive any honourable mentions soon, as calls go out for more economic and monetary stimuli, we think the contribution of European middle-market private equity firms deserves to be pointed out. In particular, as discussed in this report, the asset class has been focused on:

- Putting investor capital to work, building economically stronger businesses that can tap international growth markets and better weather the next financial storm;
- Offering alternative finance solutions (*e.g.*, new credit funds) and providing family businesses and entrepreneurs liquidity as the continent's financial institutions retrench and repair their balances sheets;
- Consolidating fragmented markets to create more efficient pan-European industry leaders; and
- Returning capital to institutional investors, such as pension and endowment funds, so they are in a stronger position to address their long-term obligations.

Call us biased, but we think that private equity groups, especially those at the lower and middle markets, are best placed to ensure that the necessary structural reform—removing barriers to doing business—that ECB chief Mario Draghi continues to demand, actually translates to stronger, more dynamic and competitive economies.

For the asset class to continue to grow and contribute to the European and broader global economy, it remains essential that regulators, politicians, the media and the public gain a deeper understanding—even an appreciation—for how private equity works to create value. We think this is likely to be the best defence against costly and unproductive industry regulation. Duane Morris hopes we have made some progress in telling this important story.

Duane Morris' The State of the European Private Equity Middle Market was prepared with the assistance of the firm's outside advisor **David Haarmeyer**.

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Trond Bjørnøy joined Norvestor in 1989 as CFO, and since 1991, he has led investments within most of Norvestor's core industries, including oil services and maritime equipment. He is Chairman of Norvestor Equity and its Executive Committee. He is also currently the Chairman of Advantec, Marine Aluminium, iSurvey and Future Production and is on the board of Johnson Metall. Previous board positions include Wema, SCAN Geophysical, Akva Group, Aalesundfisk, Selmer and PGS. Prior to joining Norvestor, Mr. Bjørnøy spent two years as a Manager within the finance division of Eksportfinans (Norwegian Export Credit Agency) and two years at Grindlays Bank before being appointed as Finance Manager of Selmer Sande Group, a leading construction company. Mr. Bjørnøy holds an M.Sc. degree in Business Administration from the Norwegian School of Economics and Business Administration.

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Craig Donaldson is a founding partner of the firm, prior to its independent formation as HgCapital. With 25 years of experience advising institutional investors on alternative investment strategies, his professional responsibilities have included asset acquisitions and disposals, portfolio management, financial analysis, sector coverage, team management, business strategy, fundraising and client service. Mr. Donaldson is a member of HgCapital's Executive Committee. He leads the partnership's client and fundraising activities, oversees fund co-investments and manages the firm's business planning and corporate strategy work. Mr. Donaldson serves as a member of the Babson College Board of Trustees and is a member of its Endowment Investment Committee. He is also a board member of the European Venture Capital Association and Chairman of the EVCA's Mid-Market Council. He holds a degree in Entrepreneurial Studies from Babson College.

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Dr. Andreas Fendel cofounded Quadriga Capital in 1995. Since then, the firm has advised the Quadriga Capital Private Equity Funds to invest in more than 40 medium sized companies in Germany, Austria, Switzerland and neighbouring countries, as well as more than 50 add-on investments. He has led and managed multiple acquisitions and sales of companies in the manufacturing, industrial services, consumer products, healthcare, chemicals and retail sectors. He has held several positions at the European Private Equity and Venture Capital Association (EVCA). Prior to Quadriga Capital, Dr. Fendel was a cofounder of CWB Germany from 1991 to 1995. From 1988 to 1991, he was a leading member of the team that established Citicorp Venture Capital's (CVC) private equity operations in Germany. He received his master's and Ph.D. from the University of Cologne.

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José María Muñoz is one of the founding partners of MCH Private Equity, a mid-market buyout fund operating in the Iberian Peninsula with approximately €500 million under management. The firm was founded in 1998 and has invested in over 30 companies over the last 16 years. Within MCH, Mr. Munoz has participated in multiple transactions in a variety of industries, such as construction materials (Azulev), business services (Qualytel), equipment manufacturing (Talgo), consumer products (Gamo, Europastry) or consumer services (Televida). Currently, he serves on the Boards of Talgo and Europastry. Prior to MCH, he worked several years as a consultant for McKinsey & Company in Spain and the U.S. and the former Andersen Consulting. He holds an M.Sc. in Industrial Engineering and an M.B.A. from Harvard Business School. He has been for several years an external Professor of Entrepreneurship at Instituto de Empresa and is active in several business associations.

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Claudio Sposito is the President, Chief Executive Officer and Chairman at Clessidra. He founded the firm in 2003. Previously, Mr. Sposito served as the Managing Director and Chief Executive Officer at Fininvest S.p.A. for four years. Mr. Sposito also served as a Managing Director at Morgan Stanley & Co. for 10 years, where he was Head of Investment Banking in Italy. He also worked at other leading international financial institutions, including Barclays Bank, Standard Chartered and Citibank. Mr. Sposito speaks Italian and English. He serves as a board member of Buccellati Holding Italia. He served as a Director of Pirelli & C. S.p.A. from October 21, 2013, to July 2014. Mr. Sposito holds an M.B.A. from American University in Washington, D.C. and a degree in Architecture from the University of Rome.

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Helena Stjernholm joined IK Investment Partners in 1998 and became a Partner in 2007. Ms. Stjernholm is head of the Swedish/Finnish team and a member of the Executive and Investment Committees. Prior to joining IK, she worked as a management consultant for Bain & Company in Stockholm. Ms. Stjernholm graduated from the Stockholm School of Economics with an M.Sc. in Economics and Business Administration.

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William (Bill) Watson is Managing Partner of Value4Capital, a Central European-focused private equity firm. Mr. Watson joined the European Bank for Reconstruction and Development in 1992. He moved in 1997 to Baring Private Equity Partners to raise and invest the €86m Baring Central European Fund. With this fund, he joined Société Générale Asset Management as Chief Investment Officer for Eastern Europe Private Equity in 2005. There the team raised and invested SGAM Eastern Europe, a €156m fund. In October 2011, he and his partners spun out to become Value4Capital, continuing to advise the fund. He is a member of the European Private Equity and Venture Capital Association's (EVCA) Mid-Market Platform Council and the Chairman of its Professional Standards Committee.

ABOUT DUANE MORRIS

With private equity lawyers working in the middle market across our global platform, coupled with experience in key verticals and the deep capabilities of more than 700 lawyers from all major practice areas, Duane Morris creates competitive advantage for participants across the industry.

For GPs, we deliver insights that optimize transactional value for both sellers and buyers in control and non-control investments and with exit strategies, and support portfolio company growth strategies. We also provide guidance on fund formation and advise on market LPA terms and regulatory issues. **For LPs**, we review LPA terms and advise on efficient, effective investment strategies, including co-investment and direct investment; alignment of interests; transparency; and governance issues. **For business owners**, we advise on growth strategies—not only on the mechanics of full or partial exits, but also on crafting wealth-planning approaches designed to positively impact economics for the owner.

Our PE Forum events, LP Institutes and *Connections* publications contribute to the industry's thought leadership, providing business perspectives through the eyes of leaders in the middle-market private equity space.

Given our strategic firmwide focus on private equity, broad experience in major industry sectors and an innovative culture deeply committed to client service, we are regularly called upon to work with the most sophisticated and demanding players in the private equity marketplace.

Duane Morris is proud to be an Official Sponsor of Growth™ of the Association for Corporate Growth (ACG).

ACG drives middle-market growth, providing local communities with global reach through 56 chapters worldwide. ACG's exclusive data, content and networking allow members to access capital, make deals and drive corporate growth.

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ABOUT THE EVCA

The EVCA is the voice of European private equity, whose membership covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices, and associate members from related professions. We represent 700 member firms and 500 affiliate members. The EVCA shapes the future direction of the industry, while promoting it to stakeholders, such as entrepreneurs, business owners and employee representatives. We explain private equity to the public and help shape public policy so that our members can conduct their business effectively. The EVCA is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practices through our training courses. We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis. The EVCA has 24 dedicated staff working in Brussels to make sure that our industry is heard.

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