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Private Equity Trend Report 2017

Rising above uncertainty

11th annual survey on current developments in German and European private equity investment

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Preface

Dear colleague,

Following the revival in private equity activity since 2014, there has been an inherent optimism within the industry that I am happy to confirm has continued through 2016. We have seen the number of deals not only maintain the high levels achieved in recent times, but increase further by 5% all over Europe and by a strong 22% in Germany, Austria and Switzerland.

Once again, this has not been an easy ride having been achieved against a backdrop of macroeconomic and geopolitical uncertainty, in particular regarding the unexpected Brexit vote and outcome of the US elections, to name just two. Despite the uncertainty that this has created, record levels of fresh capital and an abundance of cheap debt have led to even higher price expectations from sellers. It has again been refreshing to see how the PE industry has continued to demonstrate that it has learned from the financial crisis and shown that they are not buyers “at any price”. The positive conditions have clearly also led to a positive exit environment with portfolio exits in the DACH region up 19% on 2015.

The industry continues to be faced with the challenge that supply of cash exceeds supply of assets, a situation that makes it even more important to develop convincing and sustainable equity stories in order to put the cash to work. The industry has already substantially adapted itself to the longer-term holding periods and a stronger focus on operational improvement to realise value creation. A factor that is entering not only existing portfolio companies but also the diligence phase of acquisitions is digitalisation, and it is clear that this has gained significance in not only the approach to portfolio management but also the mindset of the PE community.

As noted in the PwC Annual Global CEO Survey and the sentiment communicated at the recent Davos summit, with continued uncertainty expected in 2017 there are definitely challenges ahead. The underlying fundamentals for successful PE investments are, however, still intact and with a strong deal flow expected, we anticipate this to be another good year for the industry.

In conclusion, our report holds good news for the German market: Germany is expected to be the No. 1 investment destination within Europe for PE in 2017. Having consistently been the most attractive continental European country, its rise above the UK for the first time since we have been conducting this survey is highly likely to be driven by the continued uncertainty around Brexit. Germany’s ability to remain stable in the face of nearby market turmoil, the strength of its middle market and the ever increasing “safe haven” status are factors that, despite the potential disruption of its own upcoming elections, continue to draw firms looking for high-performing portfolio companies and dependable returns.

As always our thanks go to all those who participated in this year’s survey and shared their opinions. We look forward to working with you again in 2017.

Steve Roberts
Private Equity Leader

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In conversation with Steve Roberts, Private Equity Group Leader at PwC in Germany

Following strong growth in deal volume in Europe in 2014, 2015 maintained that high level and 2016 saw it surpassed by a further 5%. The market seems to be settling for the fact that it is just not possible to pause and wait for less turbulent times – particularly as these don't seem to be in sight. The uncertainties that defined the market in 2015 – stock market and currency volatility, geopolitical and economic uncertainty, low macroeconomic growth – have all been there again and defined 2016. The economic framework and competitive conditions of the private equity market have not eased either – the competition is fiercer than ever seeing even more participants as well as different players entering; investment opportunities are still scarce and value expectations, which although on average are slightly lower, are still at a very high mark.

Private equity companies continue to place more emphasis on developing equity stories based on operational value creation and digitisation initiatives, as well as targeting sectors ripe for market consolidation and developing buy-and-build strategies. With anaemic growth in Europe, there is an emphasis on driving down portfolio company costs and improving margins, while focusing on increasing the top line by sales force effectiveness initiatives as well as seizing new digital sales channels.

In all of this Germany is well on the way to becoming the new core market for Private Equity in Europe. What this means for the future and what to expect, in conversation with Steve Roberts, Partner and Private Equity Leader at PwC Germany.

The GSA investment market has been flourishing in the past years. However, the findings in the Private Equity Trend Report 2017 seem to suggest that the boom has reached new heights.

That is correct. In 2016 in Germany, Switzerland and Austria 214 companies were acquired by financial investors. With a total of €25bn in deal value, which represents an increase of 83% compared to the prior year. That is remarkable and noteworthy for at least two reasons: first of all the level in 2015 was already substantial; the market has, therefore, grown from an already very high level. Second the private equity market in Europe has barely grown at all in 2016. The GSA region clearly stands out.

What are the reasons behind that?

One of the reasons lays surely in the Brexit referendum. The decision of the British to exit the EU, the already booming German market was given an additional boost. Even the private equity investors, which concentrated mainly on the UK, are increasingly looking towards continental Europe for investment targets. And in this case Germany is, among others, because of its strong middle market and the "safe haven" argument particularly attractive.

“Operational and digital expertise are becoming crucial in an increasingly competitive private equity landscape”

Does that mean 2017 will continue the same way that 2016 ended?

In the GSA region we have reached a level, at which it cannot be an easy task to achieve further growth. However, German private equity investors, which mostly invest their funds in Germany – are particularly optimistic for 2017. In preparing our trend study, we questioned 250 international private equity managers. The result: while in total every third participant expected growth for the coming year, the number was 43% among German financial investors. In addition 80% of German investment managers are satisfied with the current development of their portfolios. On an international level it was only 42%.

This optimism reminds us almost of the record-breaking years before the financial crisis …

On one hand that is true. On the other, however, that comparison falls short. The current private equity boom is based upon a lower leverage than then – so on the basis of much less debt so the speak. In the past year only 8% of German private equity investors chose to predominantly debt finance their transactions. This shows that the industry has become more mature. The times when returns were mainly generated by financial engineering are over. Instead the investment funds add value and drive their portfolio companies forward on an operational level. One can observe this development just by taking a closer look at the structure of the deal team. Earlier eight out of ten had a financial background. Nowadays, you meet professionals there, who predominantly come from the industry. So ex CEOs, previous COOs – and naturally more and more digital experts. PE has quickly understood that digital transformation is crucial to make portfolio companies “future-ready”. They have realised that through this they can counteract the increasing holding periods as well as the relatively low levels of macroeconomic growth.

So the boom stands on solid fundamentals?

Absolutely! However, private equity houses need to be careful not to get pulled into fierce price competition. More and more competitors from outside the industry, such as pension funds and insurance companies, are developing a taste for the private equity model; this increases of course the competition pressure. In addition, additional players such as Chinese investors, which are getting progressively more serious, are establishing themselves in the market. Many German strategic players have become buyers rather than sellers.
If private equity houses want to continue to generate lucrative returns on their investments despite increasing prices, they have no other choice but to focus even more on the operational alignment of their portfolio companies.

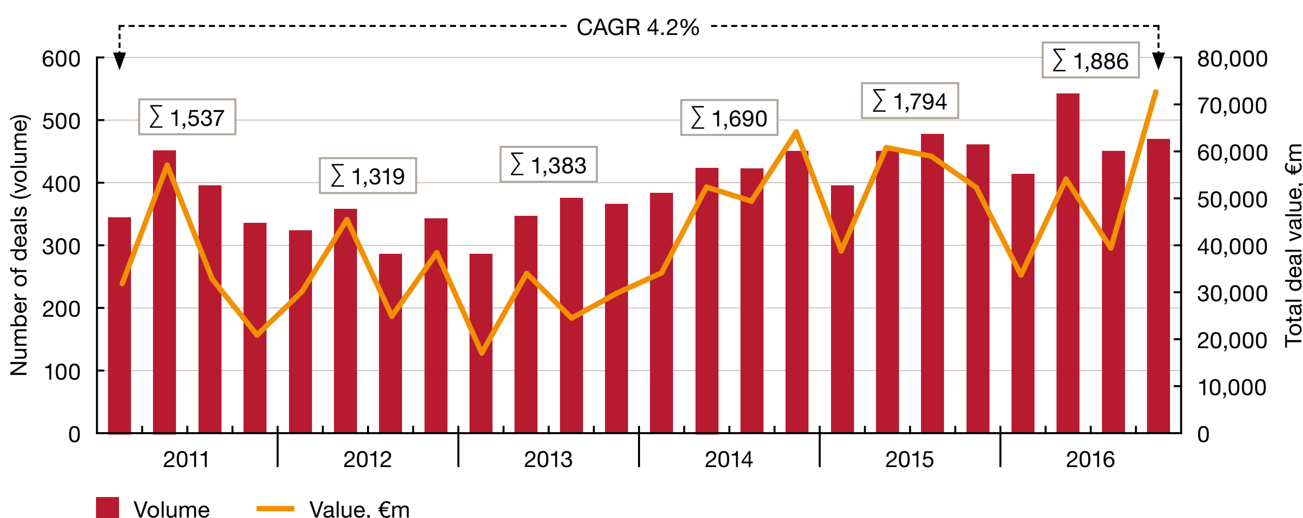
A Market Overview

1 Private Equity in Europe

Overview – The Private Equity Market in Europe

The European private equity market bifurcated in 2016, with total deal volume increasing by 5.1% to 1,886 but total deal value slipping by 5.3% to €199.9bn. This is the first time since 2013 that the number of transactions has increased while aggregate value has fallen. This follows an exceptional year for European PE in 2015 in which deal value was higher than for any year since the credit boom that came to an abrupt halt in 2008. Volume of deals has grown by a CAGR of 4.2% since 2011, albeit the dip in deal activity in 2012.

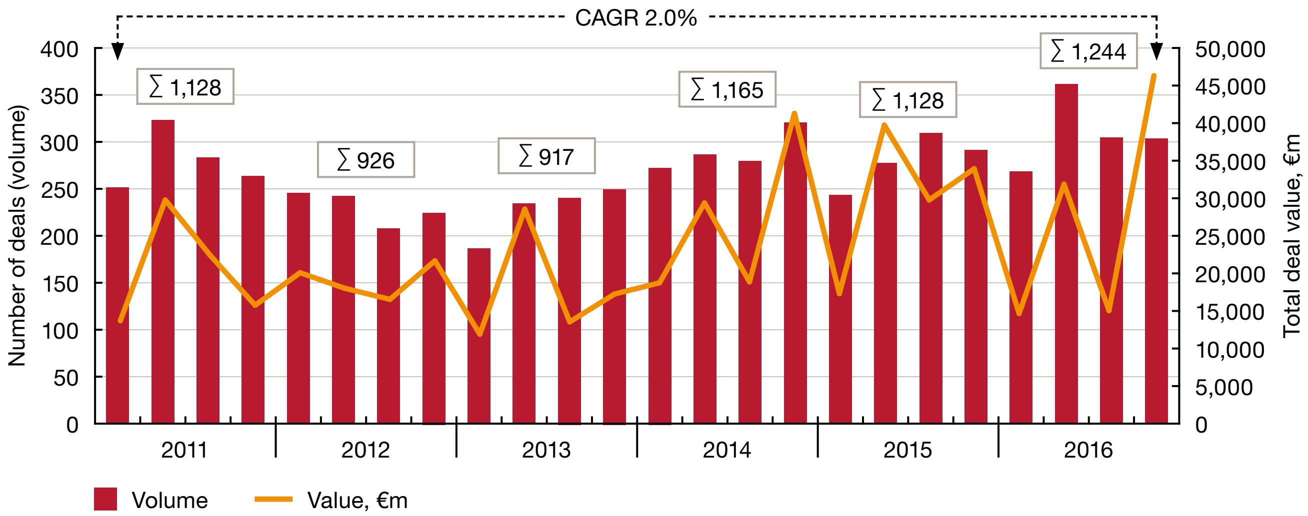
Fig. 1 European Private Equity Trends, 2011–2016



European Buyout Trends

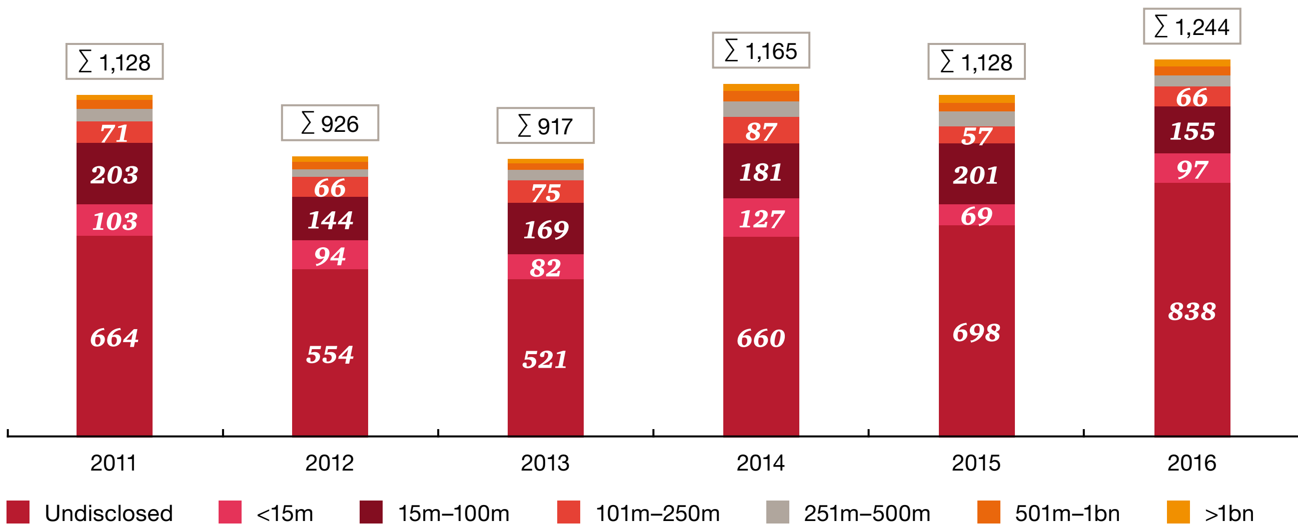
Honing in on the buyout segment of the overall private equity market, the disconnect between volume and value is even more pronounced. Volume increased from 1128 in 2015 to 1244 in 2016, an annual rise of 10.3%; at the same time value fell from €120.8bn to €107.9bn, a drop of 10.7%. After a very strong recovery in 2014, a 27% plus in buyout activity, 2015 ended with a slight minus of 3% YoY to 2014. 2016 has, however, (over)compensated for this by increasing by 10% YoY.

Fig. 2 European Buyout Trends, 2011–2016



This disparity in value can in part be explained by the relative lack of megadeal flow. 2015 was defined by an abundance of mammoth M&A transactions globally and European private equity was no exception. A total of 27 €1bn-plus deals were recorded in that year, however this fell to 22 in 2016, a 18.5% decrease YoY. Additionally, the number of mid-market deals in the €251m–€500m bracket dropped substantially from 48 transactions to 35, a YoY fall of 27.1%.

Fig. 3 European Buyouts, Split by Deal Size, 2011–2016



The top ten buyouts in 2016 were worth a combined €38.8bn – or 36% of the year's total buyout value. This is in line with the share of value accounted for by the largest deals last year, but there is a notable exception. The largest deal of 2016, the sale of National Grid Gas Distribution to a consortium led by Macquarie Infrastructure and Real Assets for €13.4bn in the final weeks of the year, has massively skewed the numbers.

This single deal made Q4 2016 the most valuable quarter in European private equity since the global financial crisis. Discounting this carve-out from National Grid plc would see total buyouts for the year valued at €94.5bn, a YoY decrease of 22%. Nevertheless, buyout value has grown by a CAGR of 2% in the 2011–16 period and even boasts a 3.7% CAGR in the 2010–16 period.

This volume/value bifurcation should not be confused with a significant pricing correction in the market. The median EBITDA multiple for buyouts worth more than €100m was 11.3 in 2016 and although this represents a modest fall compared to 11.4 in 2015, pricing remains relatively high due to sustained competitive tension as an abundance of undeployed capital needs to be put to work.

Interest rates remain low as governments pursue loose monetary policy to spur investment and growth. This has made the returns promised by private equity attractive to investors and resulted in net gains to their capital supplies.

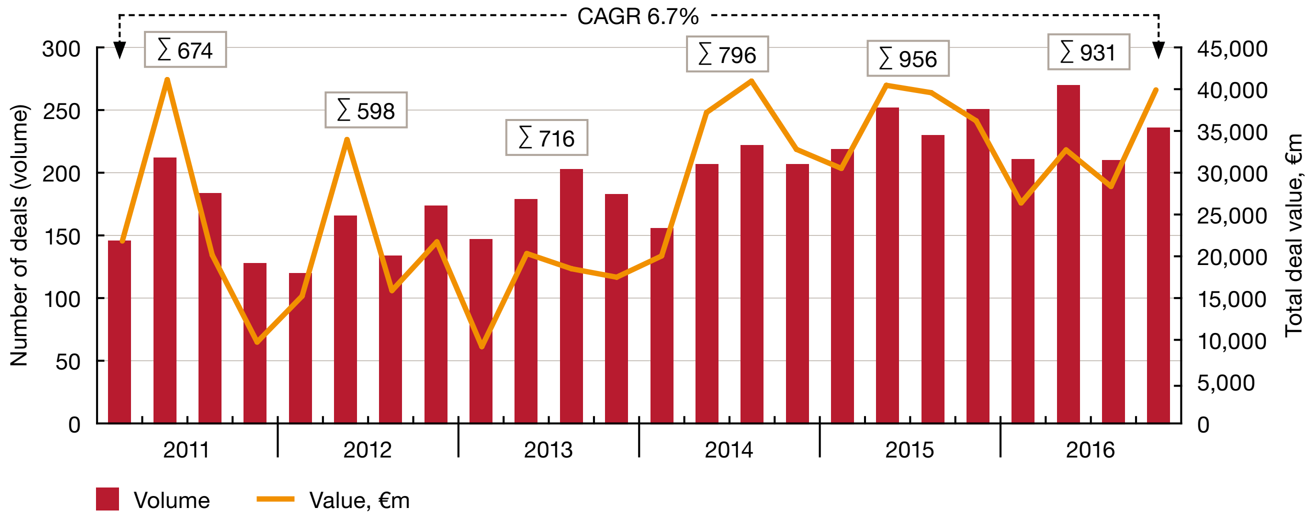
In Europe specifically, Preqin, a market research firm, estimates that in 2016 $72.2bn was raised for Europe-focused buyout strategies alone; that rises to $112bn for private equity as a whole. This means there is $167.8bn in buyout dry powder at funds' disposal – the highest level since 2008 and greater than any other year prior to or since that peak.

However, there continues to be a disconnect between the capital reserves held by funds and the quantity of deals that are being closed. This is partly the result of a feedback loop in supply and demand. The more undeployed PE capital there is, the more upward pressure there is on pricing; the higher prices are, the more cautious PE firms are in deploying capital.

Geopolitical concerns, namely those related to the UK's referendum on its future EU membership and the run-up to the US presidential election, have also played their part in making buyers more cautious. The Brexit vote in particular hampered activity as acquirers awaited any immediate economic impacts and the potential for deal pricing to ease off.

European Exit Trends

Fig. 4 European Exit Trends, 2011–2016



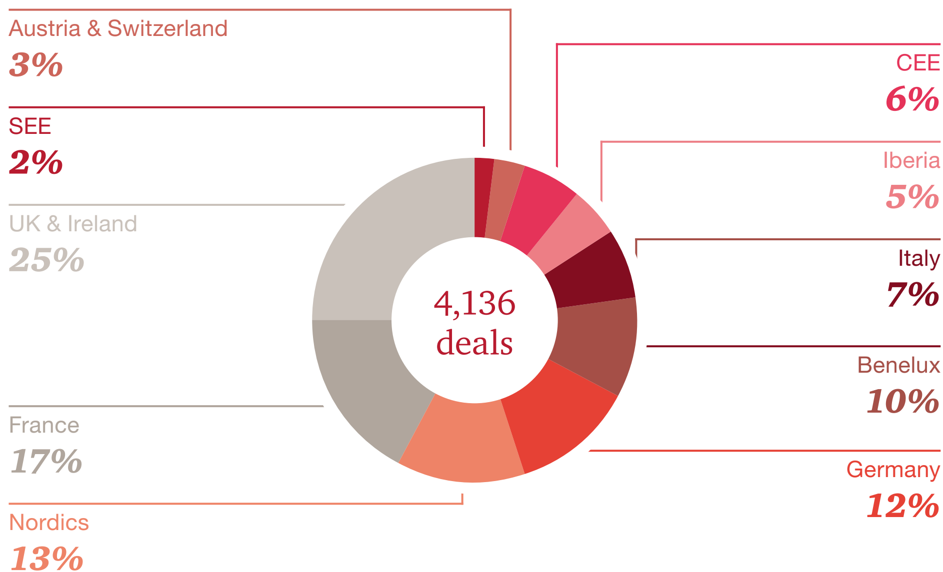
The market for exits was down in 2016, falling to 931 from 956 in 2015, a 2.6% decrease YoY. However, it is in aggregate value terms that the fall is most striking – exits sunk to €127.4bn from €146.8bn, an annual drop of 13.2%. Once again, political uncertainty and the resulting potential market and macro-economic impacts gave buyers pause for thought in the private equity and wider M&A markets. Nevertheless, this drop comes after years with high YoY volume increases – 20% in 2013, 11% in 2014 and 20% again in 2015. Value has been up as well in the past two consecutive years – rising by 100% YoY in 2014 and 12% in 2015. Therefore, compared to the vigorous growth of the prior years, the decrease in 2016 is a mild one – even more so in terms of value than in volume. However, in terms of both volume and value, growth has been on a consistent high level – recording a CAGR of 6.7% and 6.5% respectively in the period 2011–16.

The largest sale of the year came when CVC Capital Partners offloaded Formula One Group to Liberty Media Corporation for €7bn. The firm had already realised returns via dividend recapitalisations and selling minority stakes to co-investors during the life of its holding period. CVC also claimed the second-largest exit of the year with Spanish pharma company Quironsalud, which was sold to German corporate buyer Helios Kliniken for an enterprise value of €5.8bn.

Geography of European deals

Fig. 5 Buyout volume, split by region

2011–2014



2015–2016

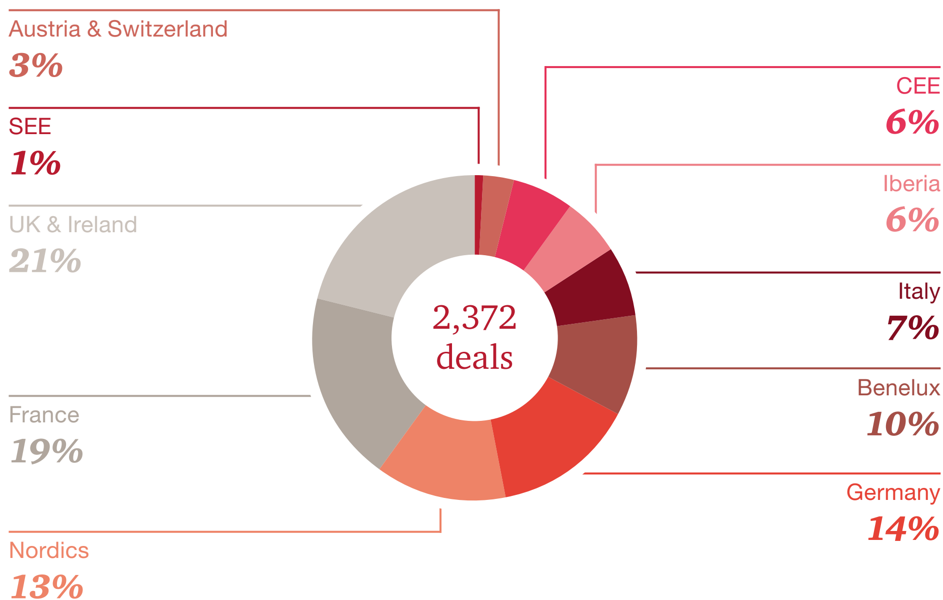
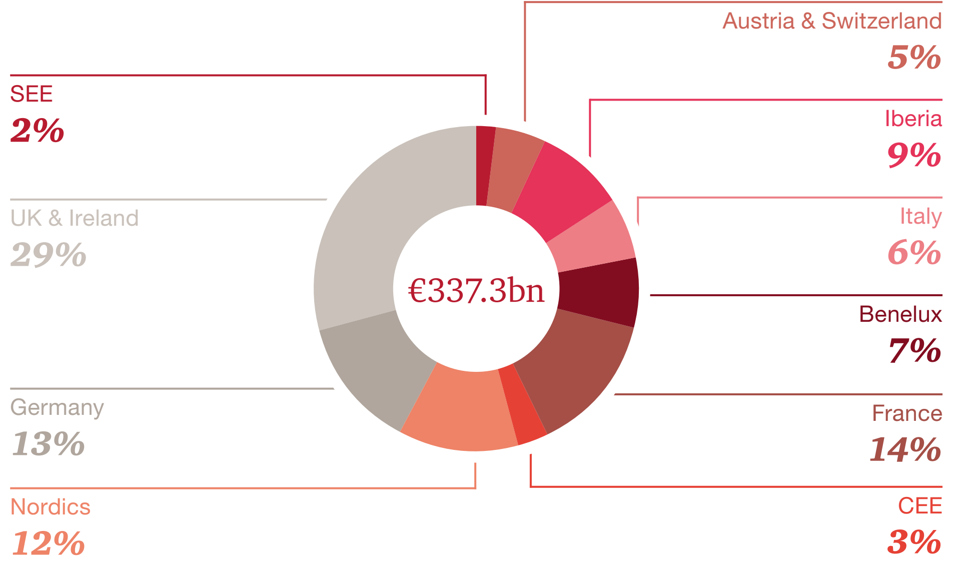
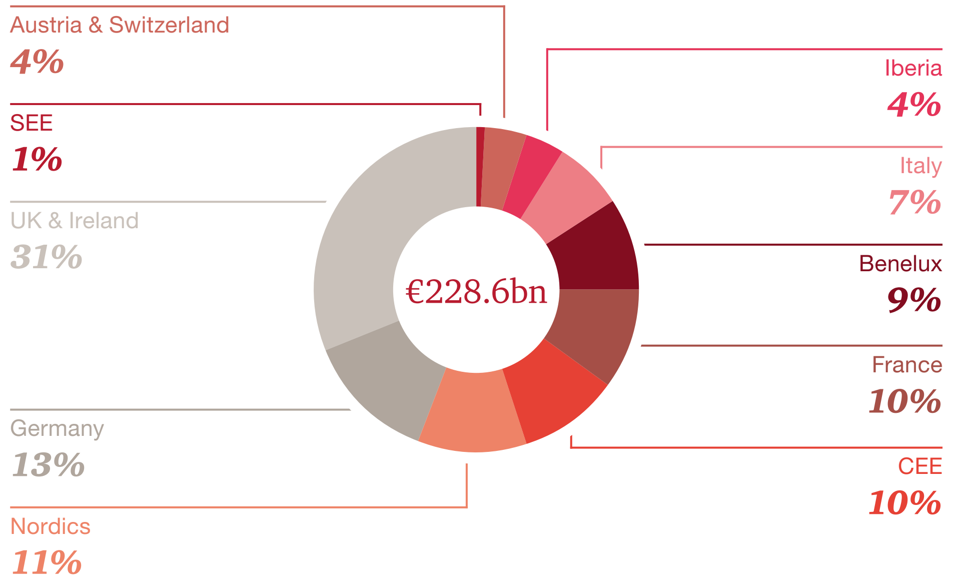


Fig. 6 Buyout value, split by region

2011–2014



2015–2016



The geographical composition of Europe's buyout activity remains relatively static over time due in part to the long-term nature of private equity investing and fund lives, as well as the maturity of each market. For instance, the UK and Ireland continues to dominate in terms of both value and volume, as has been the case since the private equity industry first established itself in Europe. However, the uncertainty precipitated by the Brexit vote has had a noticeable impact on dealmaking. In 2015–16 the UK and Ireland accounted for 21% of buyout volume, a significant fall from its 25% share of deals in 2011–2014. This has yielded to gains of 1 percentage point over the same period in Iberia (6%), while France and Germany gained 2 percentage points to claim 19% and 14% respectively of buyouts.

However, data for aggregate value tells a different story. With six of the top 10 largest deals to their name in 2016, the UK and Ireland saw their share of buyout value increase from 29% to 31% in 2015–16 – although this was helped majorly by the National Gas Grid Distribution deal. Furthermore, while France has historically been Europe's number two market by value, it has slipped to joint-fourth with CEE (10%) in 2015–16, behind the UK and Ireland, Germany (13%) and the Nordics (11%).

Industry focus

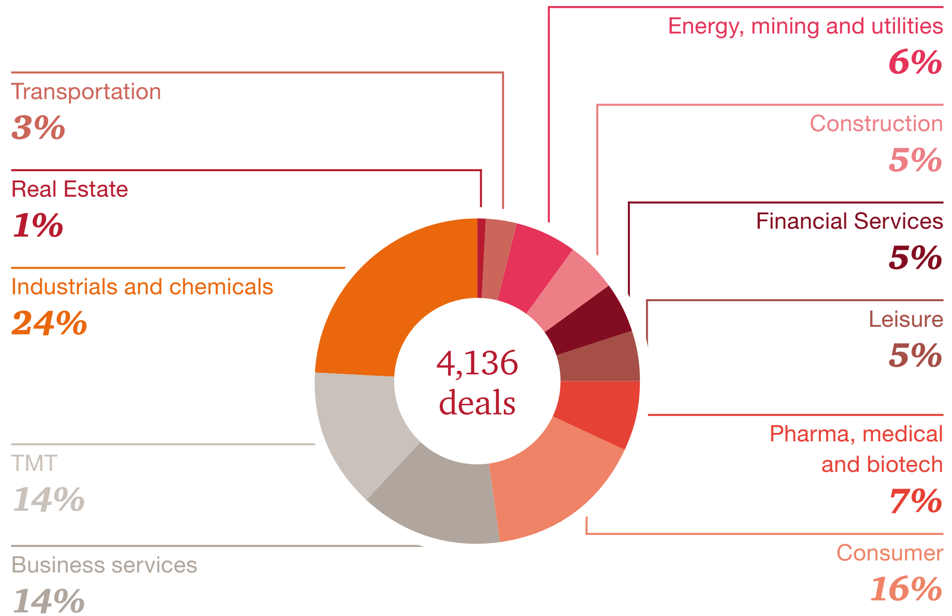
The sector split of deal activity has seen little change over time. Industrial and chemicals continues to account for the most buyout by both volume and value, although it has lost some share in 2015–16 compared to 2011–14, shedding 2 percentage points by volume and value to 22% and 15% respectively.

Over the same period business services lost 4 percentage points to account for 8% of buyout value, making it one of the biggest movers despite the volume of transactions in the sector growing by 2 percentage points to 16%.

There is a notable disparity between the high value (12% of deals) and low volume (5%) of energy, mining and utilities transactions as investment is concentrated in few but large buyouts. This has become even more pronounced as the result of the €13.4bn National Grid Gas Distribution acquisition by Macquarie Infrastructure and Real Assets in the final weeks of the year, as well as the €3.8bn purchase Gas Natural Fenosa by Global Infrastructure Partners. This indicates that private sponsors are optimistic about an uptick in energy prices following the oil recovery in 2016.

Fig. 7 Buyout volume, split by industry

2011–2014



2015–2016

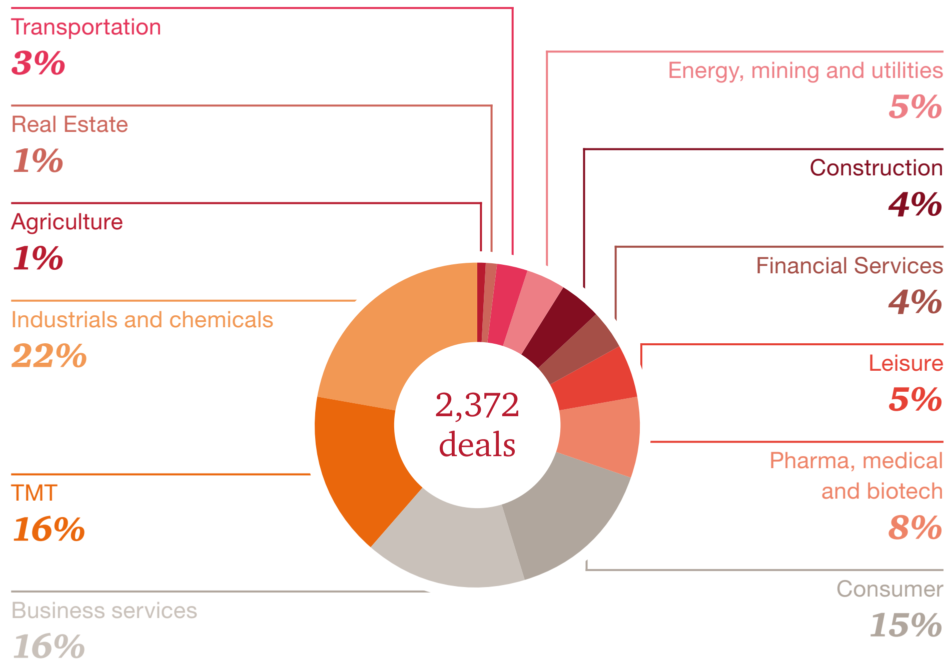
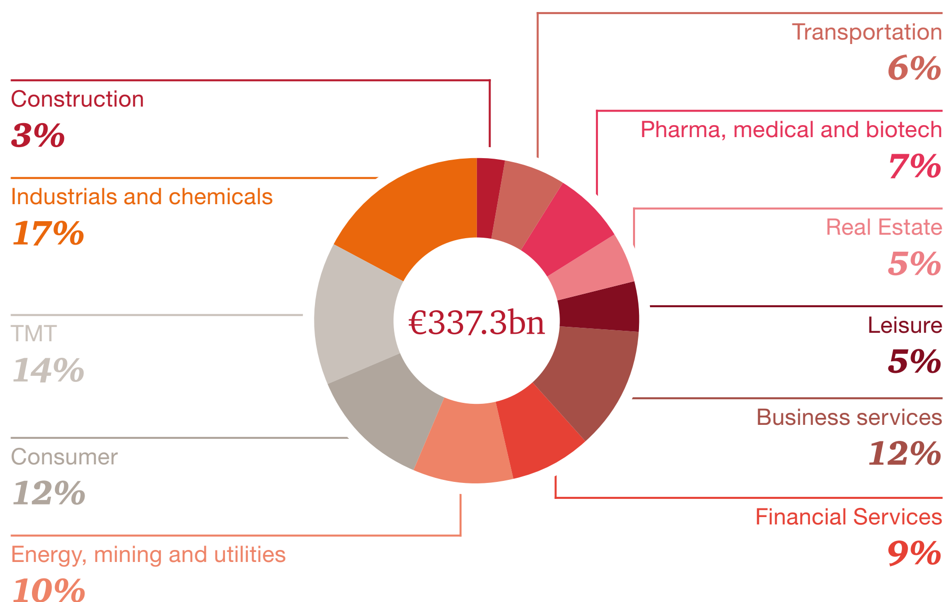
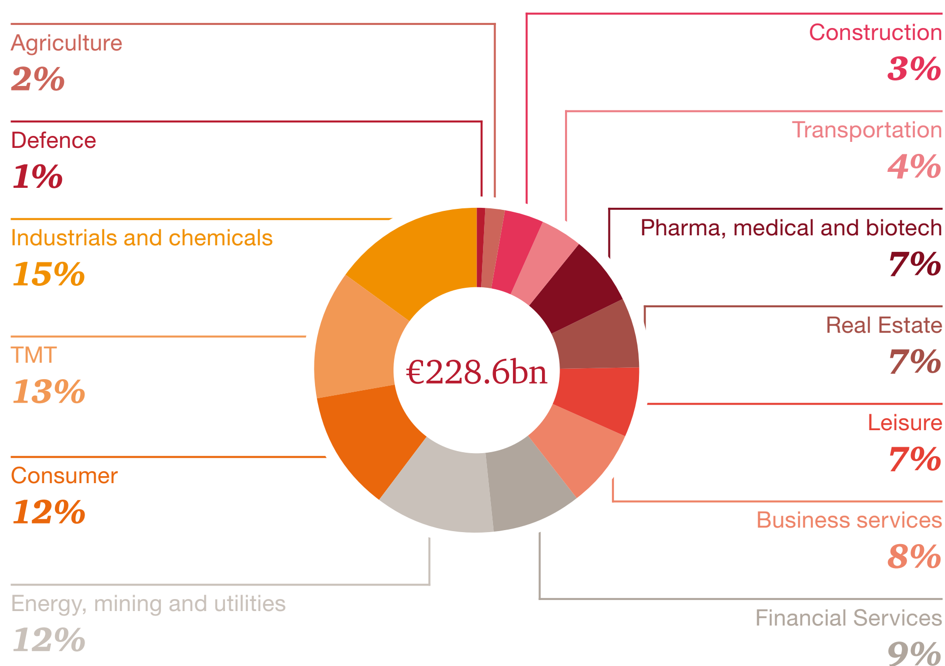


Fig. 8 Buyout value, split by industry

2011–2014



2015–2016



The outlook

Unlike recent years, 2016 began with a high degree of caution. Volatility in global equity and credit markets in the latter half of 2015 continued into the start of the new year, stalling buyout activity, particularly in the upper end of the market. The first half of the year was also marked by doubts over the outcome of the UK's Brexit referendum. While the country's shock decision to secede from the European Union has created long-term political uncertainty, and potential instability, in Europe, the immediate after effects have had little economic impact, easing investors' fears.

The US presidential election was another major milestone. However, in the wake of Donald Trump's unexpected election stock markets the world over have rallied to unprecedented heights on the assumption that his policies will boost US growth – indeed, the Dow Jones Industrial Average hit 20,000 for the first ever time in late January. The Federal Reserve's incremental base rate increase to 0.75% in December is a further positive sign.

Europe, however, is some way behind. While inflation has climbed to a three-year high, the European Central Bank has kept the base rate at a historic low of 0% to sustain what continues to be a slow and protracted recovery.

Overall, 2016 was a relatively robust year for European PE, with deal volumes ticking upwards despite a fall in larger buyouts. In 2017, PE firms face an all too familiar prospect. Mass stores of dry powder and frothy stock markets are keeping prices stubbornly high. This will ensure capital deployment continues to be the industry's number one challenge.

Deep dive: DACH Spotlight

DACH Spotlight

PE dealmaking surged in Germany, Austria and Switzerland (DACH) in 2016 in terms of both volume and value. By number, deals were up 22.3% YoY to 324, while total value rose by as much as 51.7% to €41.3bn. Value has risen by a CAGR of 6.9% compared to volume, which increased by a CAGR of 5.2% in the 2011–16 period.

Drilling down into buyouts, volume was up by 28.1% YoY to 214 deals, and aggregate value increased by a massive 82.7% to €25bn. It's worth noting that value in Q4 was close to equaling all of the preceding quarters combined. This is due to timing effects and thus the fact that two of the top 10 largest deals of 2016 occurred in the region during the final three months of the year. These were the €3.3bn acquisition of German real estate firm Officefirst Immobilien by Blackstone Group, Europe's third-largest of the year, and Carlyle Group's €2.9bn carve-out of German chemicals business Atotech from French oil giant Total.

Speaking in terms of cumulative growth over the 2011–16 period value of buyouts has risen by 18%, while volume by a CAGR of 3.5%. Although the DACH region inevitably follows broader European trends and is influenced as well by global economic and political factors, it has maintained a good and steady development and has yielded above-average growth both in terms of value and volume, making the region continuously popular among investors.

These two bumper deals, plus the Canada Pension Plan Investment Board's purchase of Switzerland's Glencore Agri for €2.2bn, meant that the DACH region was responsible for 23% of European buyouts by value in 2016.

Fig. 9 DACH Private Equity Trends, 2011–2016

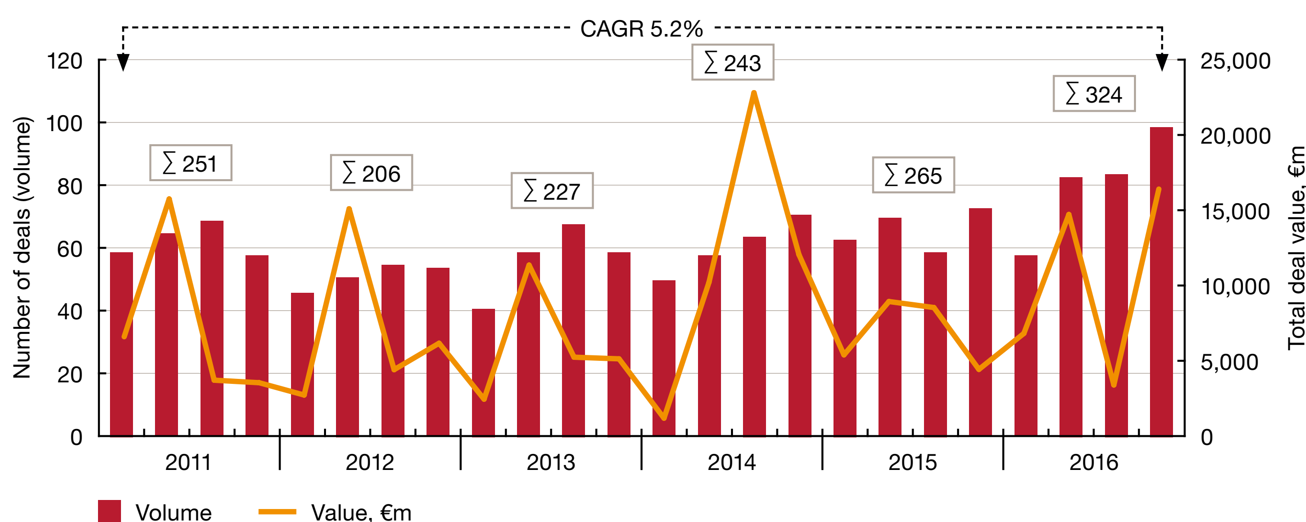
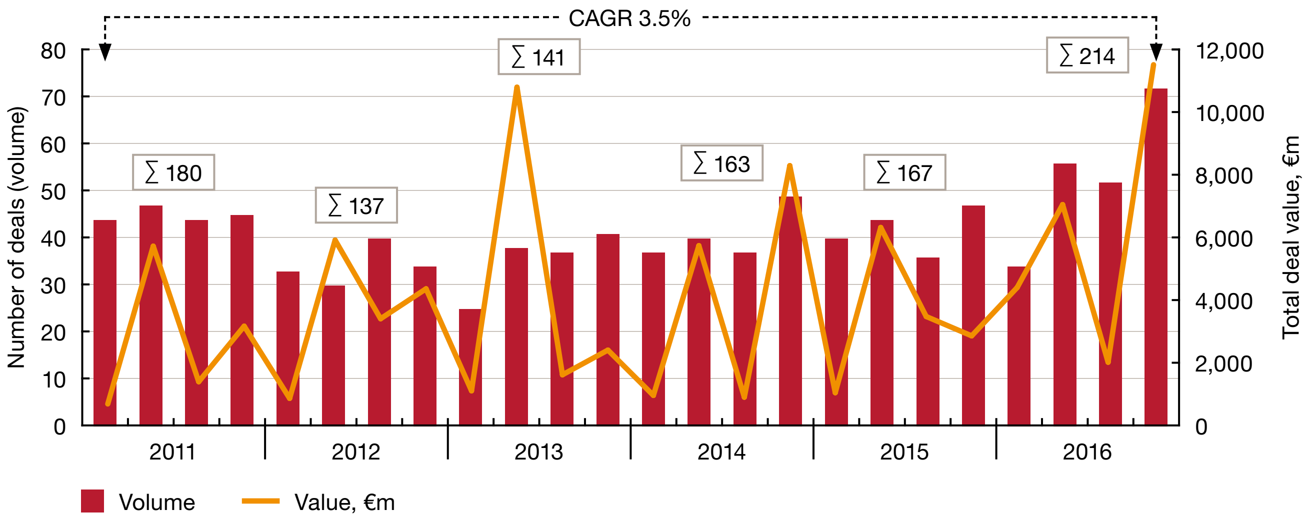


Fig. 10 DACH Buyout Trends, 2011–2016

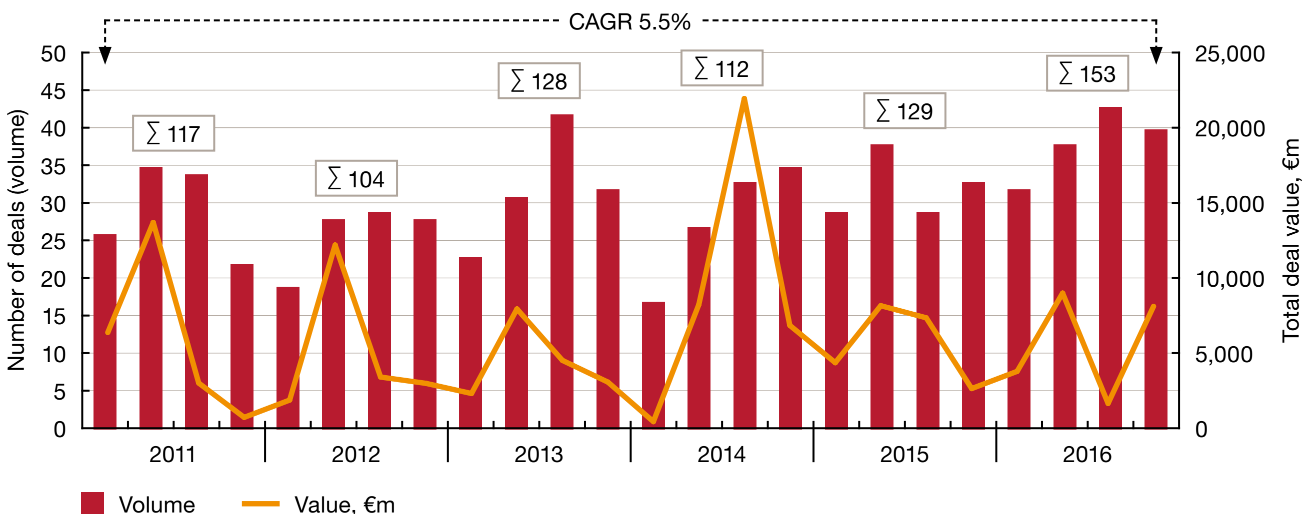


Exit figures

DACH-based exits increased in volume terms in 2016, although value was flat. The number of exits reached 153, an annual increase of 18.6%, while value stood at €22.4bn, an increase of less than 1 percentage point. The exit market grew by 5.5% in volume over the 2011–16 period and remained stable in value. The largest sale of the year saw EQT Partners offload German healthcare firm BSN Medical to Svenska Cellulosa Aktiebolaget for €2.7bn, the sixth-largest deal in Europe in 2016.

Other notable liquidity events included KKR's sale of tableware and coffee machine maker WMF to French corporate SEB for €1.6bn and Bain Capital's exit of FTE Automotive to French automotive supplier Valeo for €819.3m. All three of these companies were sold to non-DACH strategic buyers, many of which face muted growth in their home markets and have cash reserves to spend, placing their bets on the stability and growth perspectives of German assets.

Fig. 11 DACH Exit Trends, 2011–2016



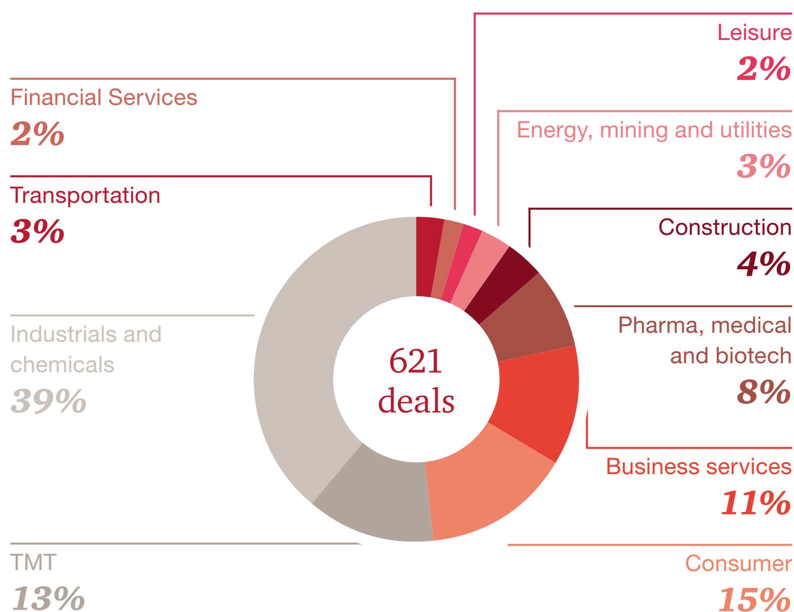
Sector focus

Industrials and chemicals remain the dominant sectors in the DACH region by some distance, owing to Germany being a substantially larger PE market than Austria and Switzerland and the fact the country's economy has a large industrial base. That said, the sector only accounted for 31% of buyout value in the period 2015–2016, a fall of 13 percentage points compared to 2011–2014, while volume lost four precentage points to equal 35% of total buyout volume in the region. Aside from the aforementioned Atotech megadeal as well as Blackstone's €1bn carve-out of Belgian group Solvay's cellulose acetate tow business, Acetow, transactions were focused on the mid-market. These included Deutsche Beteiligungs's buyout of Frimo, a machine manufacturer with revenues of €200m, as well as its acquisition of cable assembly company Dieter Braun, which has revenues of circa €80m.

The second largest sector in terms of volume has been the TMT sector, which accounted for 18% of buyout activity in 2015–16, a 5% rise compared to the 2011–14 period. This follows the general trend towards digital communications and digital sales channels and thus advertising platforms and other digital solution providers. Such are for example the acquisition of Inexio by Warburg Pincus and DBAG, as well as the acquisition of the marketing specialist Avedo by Seafort Advisors.

Fig. 12 DACH Buyout volume, split by industry

2011–2014



2015–2016

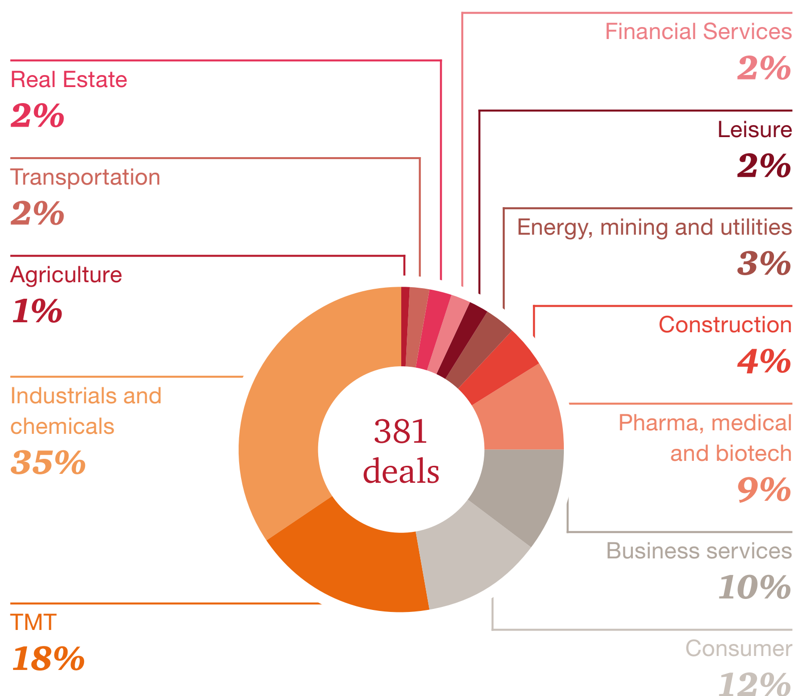
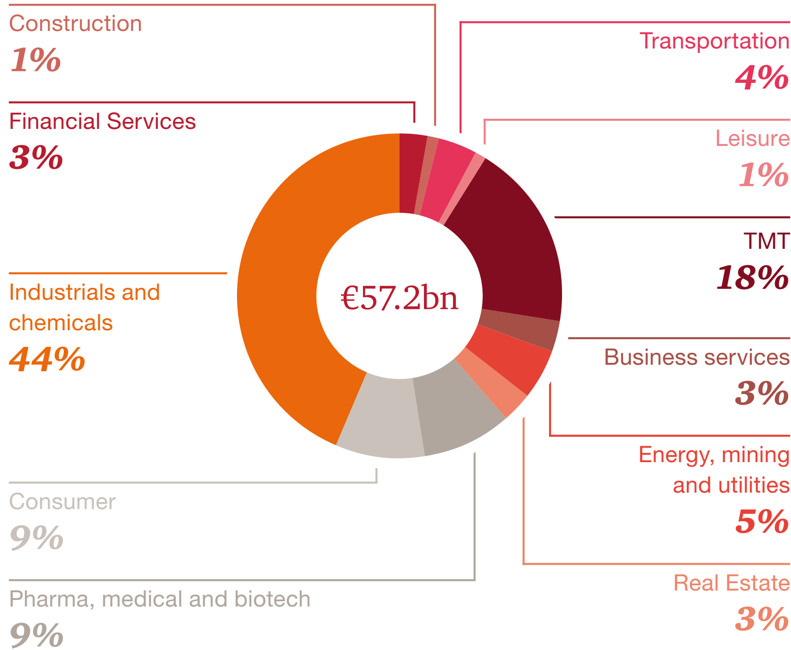
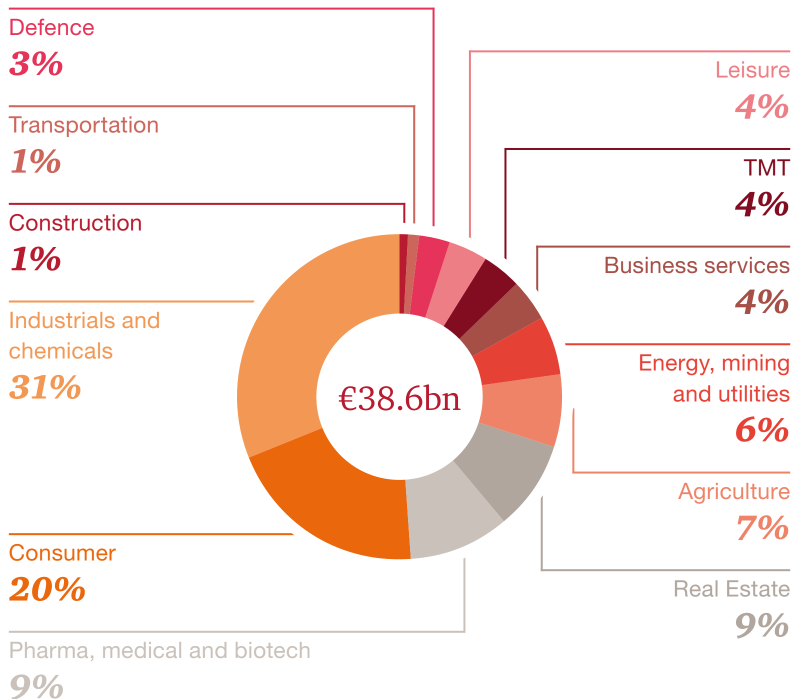


Fig. 13 DACH Buyout value, split by industry

2011–2014



2015–2016



The second-largest sector in terms of value for buyouts in the region in 2015–16 was consumer, which more than doubled to account for 20% of deals by value, making it the biggest riser despite falling in volume by 3 percentage points to 12%. This was underpinned by sizeable plays by CVC Capital Partners, which bought out German sports betting group Tipico for an estimated €1.4bn, and the €700m secondary buyout of German fashion business Schustermann & Borenstein by Permira from rival firm Ardian.

Despite historically being one of the smallest sectors in the region, high value deals propelled real estate to fourth place. In 2015–16 real estate represented 9% of buyout value – even though the sector remains one of the smallest on a volume basis – owing in large part to the €3.3bn acquisition of German real estate firm Officefirst Immobilien by Blackstone in addition to EQT Partners' €1.2bn deal to take control of Bilfinger plc's building and facility unit.

Deep dive: Benelux Spotlight

Benelux Spotlight

Overall deal activity declined by 10% in 2016 YoY, mainly due to a weaker exit market in the region. After a very strong 2014, boasting 40% YoY growth, 2015 showed moderate growth rates of 8% and the market has dipped to return to a stable and sustainable level in 2016. Altogether the region records a CGAR of 4% over the 2011–2016 period in terms of volume and has remained stable in value over the same time frame.

Buyout activity in Belgium, the Netherlands and Luxembourg (Benelux) in 2016 trended upwards by volume, however value plummeted. The number of deals reached 130, a YoY increase of 15%, while deal value tanked by 46.7% to just €6.8bn. This is owed to the fact that there were only two deals with reported values of more than €500m during the year (compared with six in 2015), only one of which was a megadeal – Chinese private equity firm JAC Capital Management leading a consortium to pay €2.4bn for Nertherlands-based company Nexperia. By contrast, mid-market deals with reported values in the €101m–€250m range increased nearly threefold (from three in 2015 to eight). Nevertheless, over the 2011–16 period buyout volumes grew at a CAGR of 5% and value has increased even more so – showing a 11.5% cumulative growth rate.

Fig. 14 Benelux PE Trends, 2011–2016

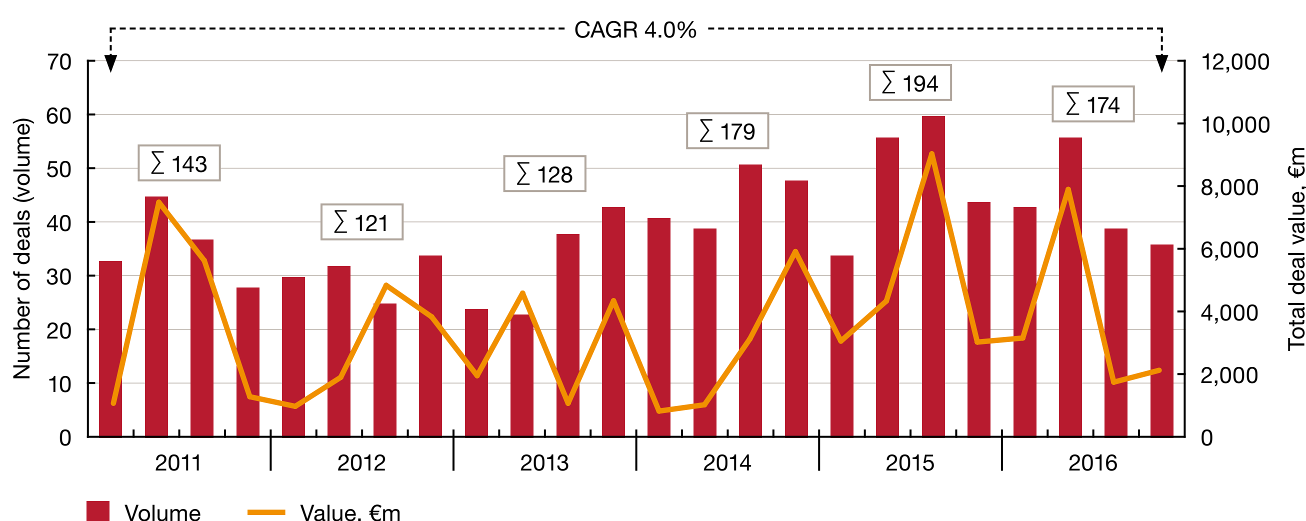
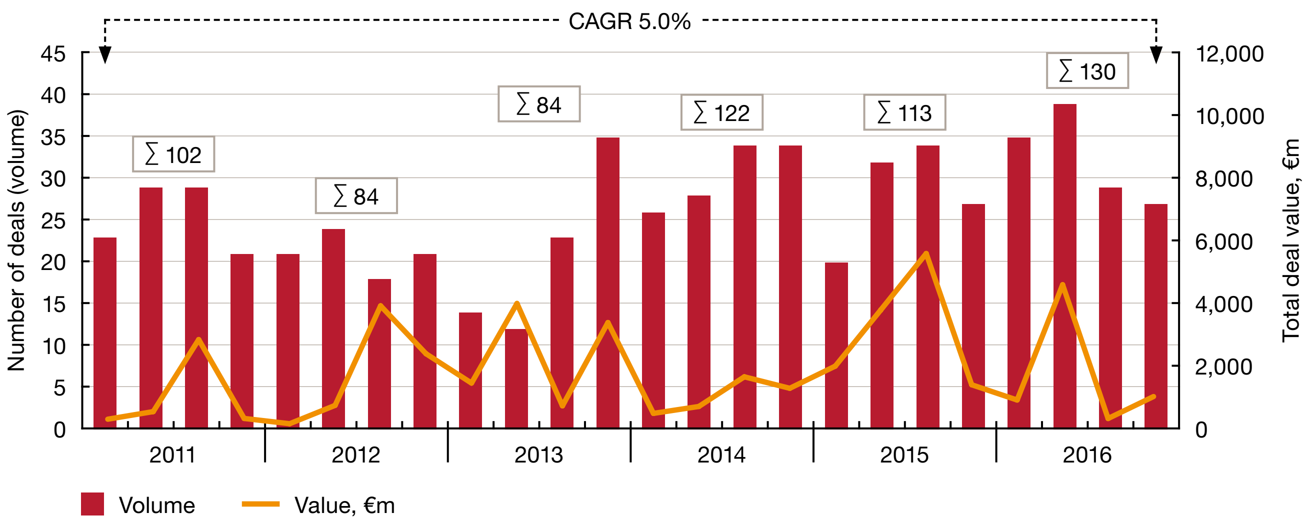


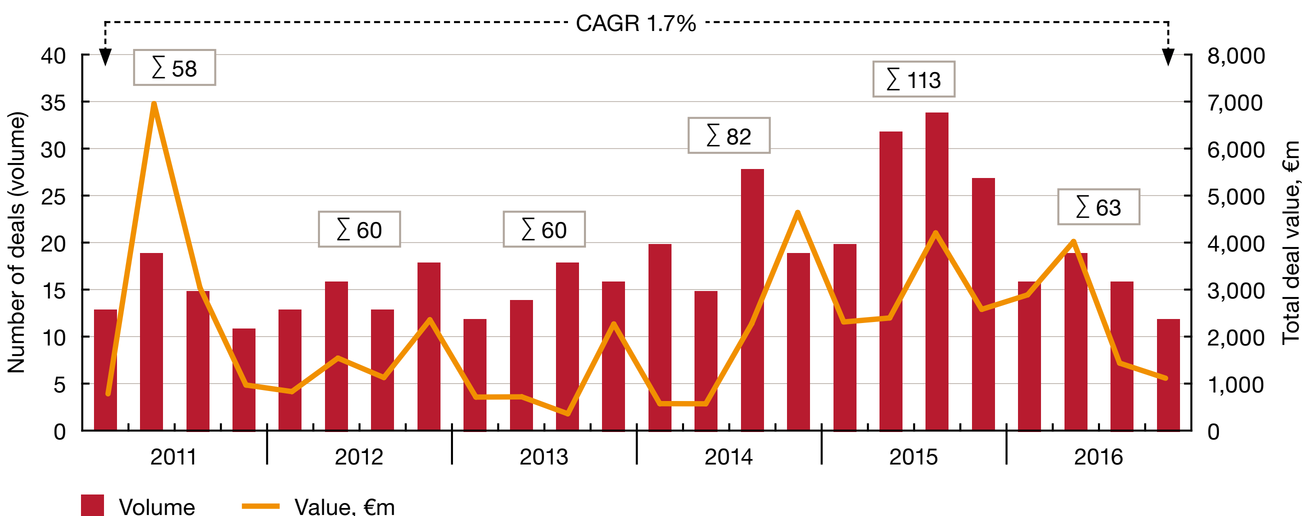
Fig. 15 Benelux Buyout Trends, 2011–2016



Exit figures

It was a weak year for exits, with volume plunging 44.2% to 63 sales and value falling by 17.7% to €9.5bn. However, here again, after a very strong exit year in 2015, which recorded a 38% increase to prior year in exit activity, the exit market has returned to a more stable and sustainable level. In terms of cumulative growth – Benelux shows a moderate but stable 1.7% increase in volume. There were sizeable mid-market sales such as Egeria selling Dutch adhesives business Den Braven for €485m in a trade sale to Bostik, and Arle Capital Partners and Eyrir Invest selling Dutch oil and gas support services provider Stork to corporate Fluor Corporation for €695m. These demonstrate that corporates are still willing to engage if complementary companies are available, but stubbornly high purchase multiples coupled with broader political uncertainty in Europe appear to have made buyers cautious in the Benelux market.

Fig. 16 Benelux Exit Trends, 2011–2016



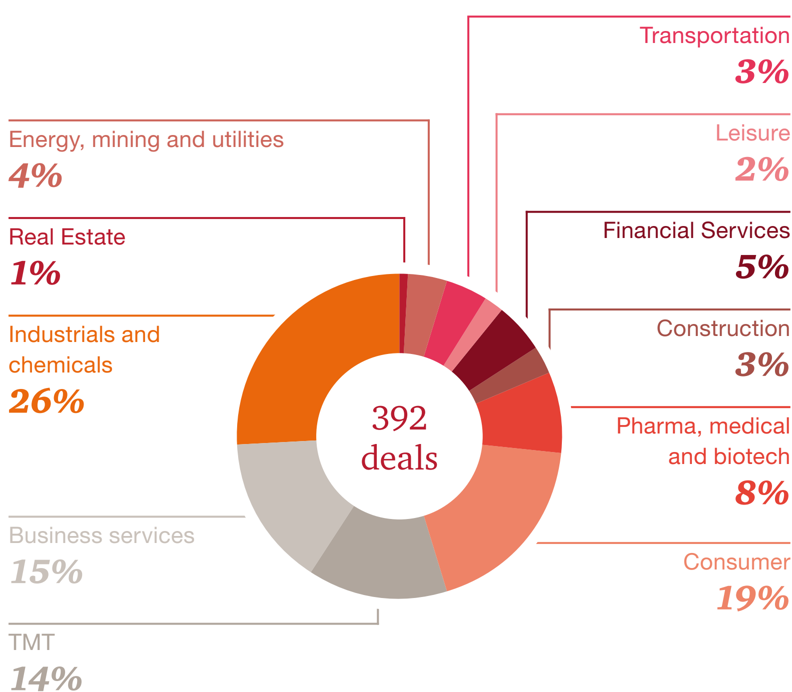
Sector focus

Industrials and chemicals continued to top buyout activity on a volume basis, despite a slight annual drop. The sector accounted for 23% of Benelux deals in 2015–2016 as opposed to 26% in 2011–2014. Looking at deal values, TMT dominated in 2016, accounting for 35% of activity compared with 23% in 2011–2014. However, this enlarged proportion is wholly attributed to a single deal – JAC's €2.4bn acquisition of Nexperia.

Financial services showed the biggest absolute increase in value, doubling from 13% to 26% of total buyout value in the region, while industrial and chemicals, and consumer also represented high deal values in 2016. A major deal boosting Benelux financial services value was 3i Infrastructure and Deutsche Asset & Wealth Management teaming up to buy Belgium-based TCR International.

Fig. 17 Benelux Buyout volume, split by industry

2011–2014



2015–2016

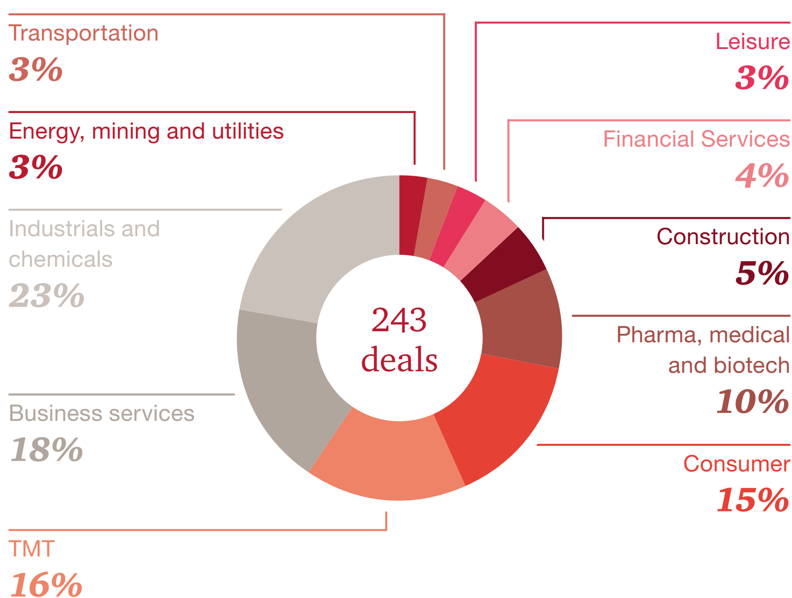
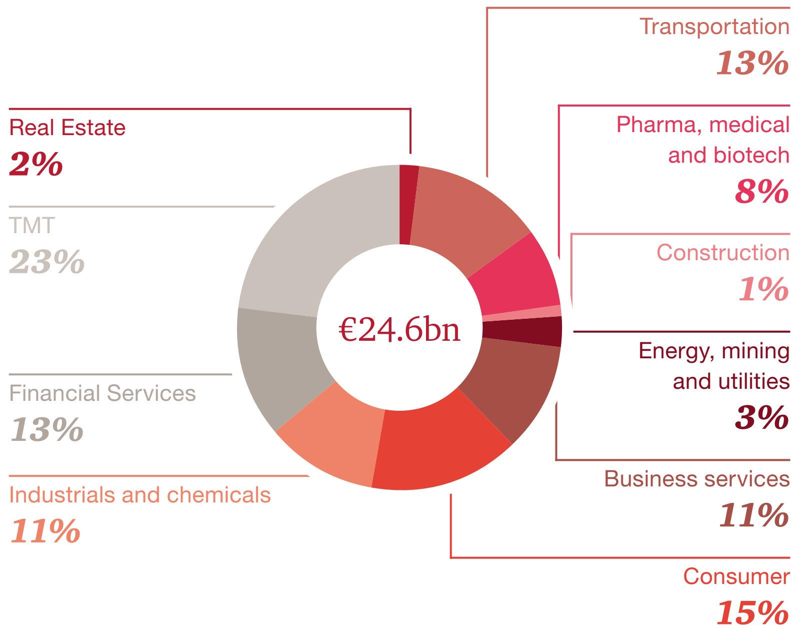
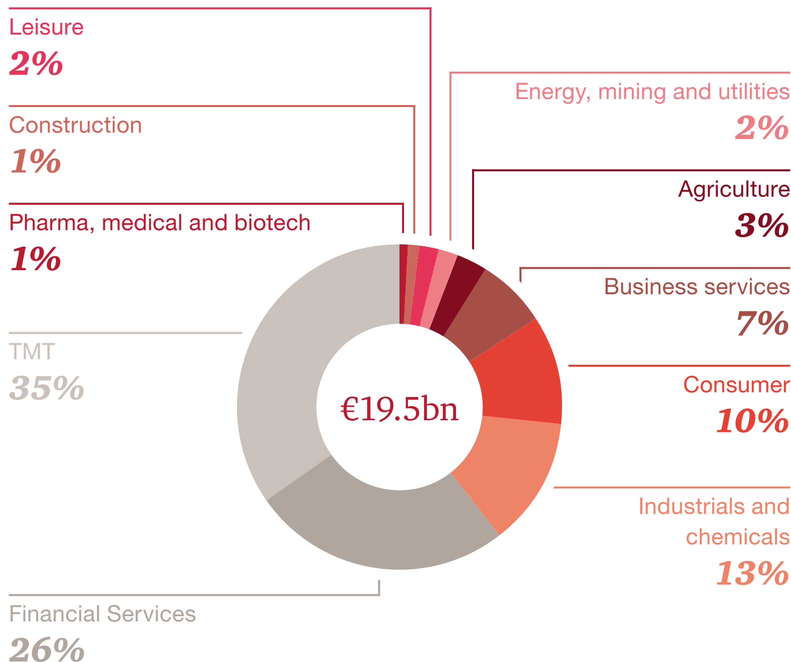


Fig. 18 Benelux Buyout value, split by industry

2011–2014



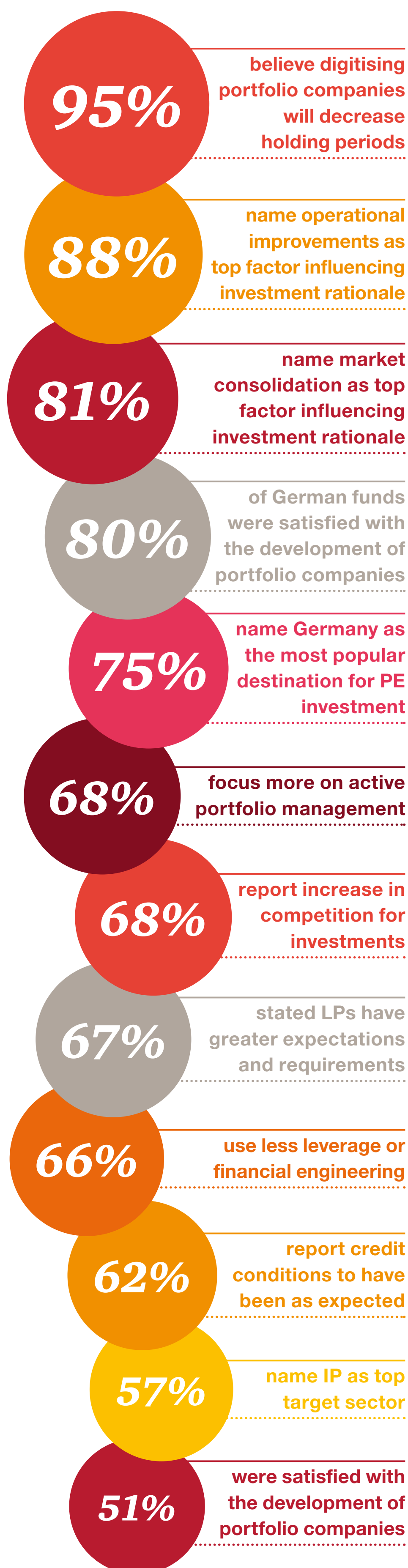
2015–2016



The moderate size of Benelux, particularly when it comes to aggregate value, makes it more prone than other regions to annual swings in sector split. The presence or absence of a single megadeal being brought to market can significantly shift the weighting away from or towards its sector.

Despite falls in buyout value and both exit volume and value, there is nothing preventing the region from rebounding in 2017, major macro-economic or political shocks notwithstanding. Local firms Gilde Buy Out Partners and Waterland Private Equity Investments will continue to deploy €1bn-plus funds raised in 2015, and market and macro fundamentals remain sound.

B Key findings



New investments 2016

Only 37% of respondents say that their firms increased the volume of new investments made in the year, compared with 51% in 2015. At the same time, more firms say they decreased the number of deals they sealed YoY, from 19% in 2015 to 29% in 2016.

Rising competition

More than two thirds of PE believe competition for assets has increased in 2016, a trend reflected across German, Benelux and international funds. As well as more and more buyout houses entering the picture, this has also been exacerbated by the emergence of insurance funds, pension funds and other institutional investors as competitors as well as LPs.

Credit on the cards

Despite a tough year, the perceived availability of credit to finance leveraged buyouts met their expectations. As much as 62% of those surveyed said financing conditions were as expected, with only 4% saying they were better than expected. A notable 34% reported that conditions were worse than expected, an increase of 10 percentage points YoY.

Can't get no satisfaction

Just over half of PE firms were satisfied with the development of their portfolio companies – the lowest on record. High valuations have been a part of this, pushing down profit margins. German fund managers (80%) report higher levels of satisfaction with the development of their portfolio companies in 2016 than Benelux managers (66%). The least satisfied are International funds (42%).

Fewer breaches

Companies in private equity ownership showed positive signs of managing their debt loads in 2016. For instance, 39% of this year's sample report no covenant breaches in their portfolio – the highest proportion since as far back as 2010. Further, only 22% say that less than 10% of their investee companies tripped debt covenants, also the smallest proportion over the same period.

PE's digital future

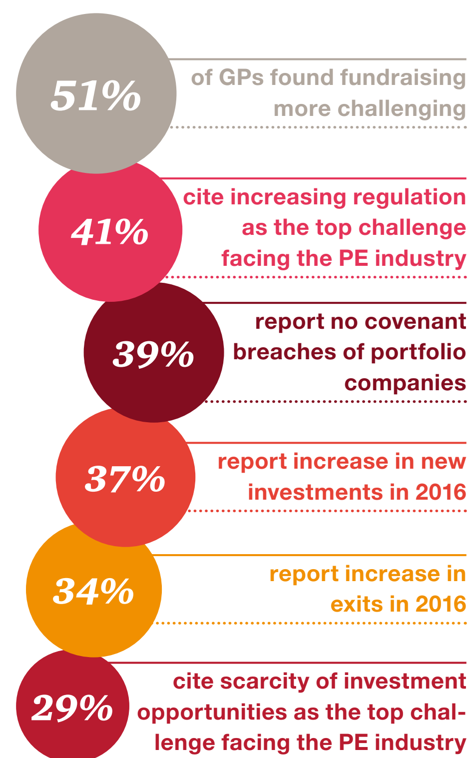
Buyout houses are under no illusion about the importance of digitisation on their industry. 90% say digitisation of operational improvements has impacted RoI, while 95% say digitising portfolio firms will shorten holding periods.

Get active

The shift away from debt and toward active involvement is well under way. 68% have said they have become more active managers in the last three years, while 66% have lowered their use of leverage or financial engineering.

Greater expectations

Limited partners have increased the pressure on private equity with their demands. The expectations and requirements of LPs has increased according to 67% of respondents, with 24% saying it is a significant increase. The major demands are increasing the volume and value of individual co-investments, great disclosure and pressure on management fees.



Looking ahead

There is a slight weighting towards moderate optimism, with 36% of PE houses overall expecting the environment to get slightly better. This compares with 26% of firms anticipating it to get slightly worse. Notably, German firms are more optimistic: 43% expect a slight improvement (35% for International funds) and only 22% expect a slight deterioration (27% International funds).

New investments 2017

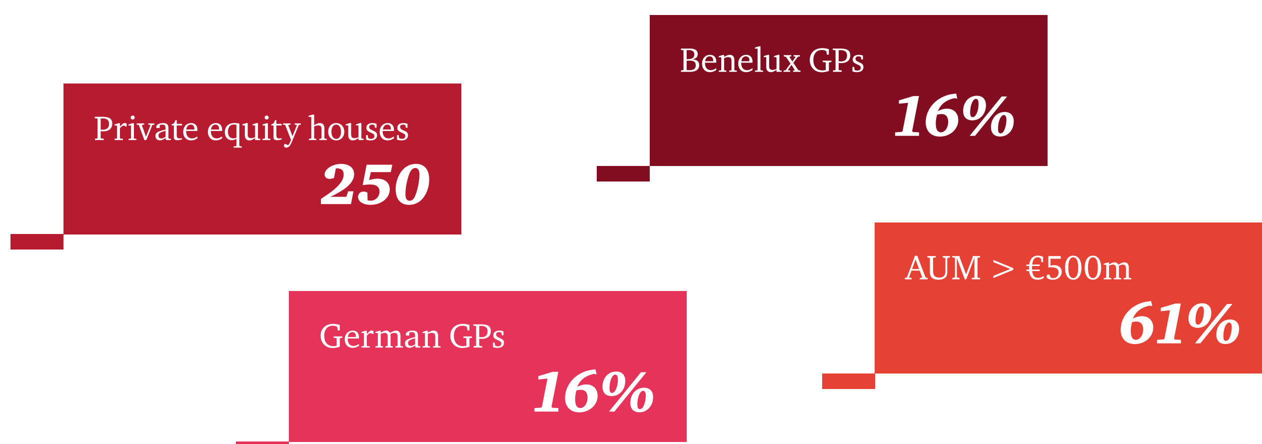
Most firms (52%) expect the number of investments they make in 2017 to increase, while a large minority (40%) believe they will stay the same. Only 8% expect completed deal volume to fall in 2017.

Investing to improve

Operational improvements are a common value driver for private equity houses and so it should come as no surprise that a majority of respondents (73% in Germany and 86% in Benelux and International) say this will be the main factor influencing investment rationales in 2017. And with anaemic growth in Europe, there is an emphasis on driving down portfolio company costs and improving margins.

Returning to action

In recent years private equity firms have adapted their business models by focusing more on active portfolio management and less on leverage to drive returns. For 68% of firms, attending to portfolio management has been a focus, while 66% have concentrated on relying less on financial engineering.

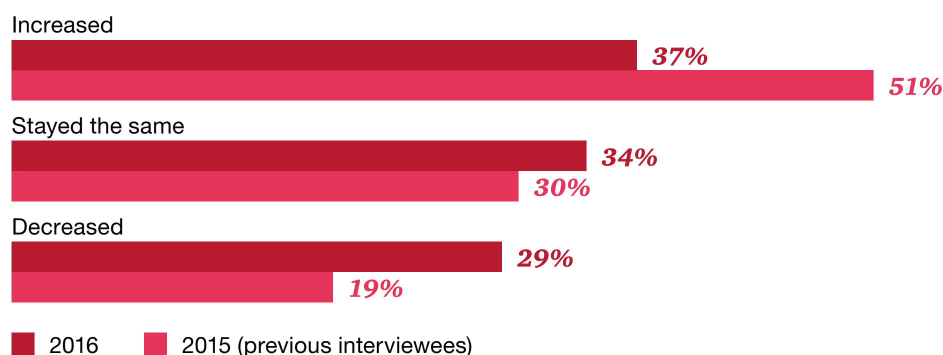


C Detailed Findings

1 2016 in review: PE staying strong

Private equity firms are still active in the market, yet a tumultuous year has made them pause for thought

Fig. 19 Development in the number of new investments compared to previous year



Sentiment changed around dealmaking in 2016 among the private equity community. Only 37% of respondents say that their firms increased the volume of new investments made in the year, compared with 51% in 2015. At the same time, more firms say they decreased the number of deals they sealed YoY, from 19% in 2015 to 29% in 2016. Nevertheless, some of the respondents comment that although deals in terms of volume have remained the same as in the prior year, they have been able to increase the value and have invested more capital than the previous years.

The start of the year was defined by volatility, both in equity and credit markets; this made mark-to-market valuations more challenging and the availability of leveraged financing less certain, dampening dealmaking activity. According to Mergermarket data, global PE buyouts in Q1 2016 numbered 662, compared with 772 in Q2 and 718 in Q3.

However, some of the participants in our survey see these current market conditions as an opportunity: "The currency volatility and the falling economy are creating investment opportunities across various industries and the reasonable valuations have increased our appetite for new investments and acquisitions this year as compared to last year's activity." such as this Partner managing an Irish fund with AUM €250–500m.

Funds also continue to face the ongoing challenge of working through the dry powder raised in 2013, 2014 and 2015, some of the strongest fundraising years on record. This has created a highly competitive environment in which high pricing is not commensurate with the relative lack of economic growth.

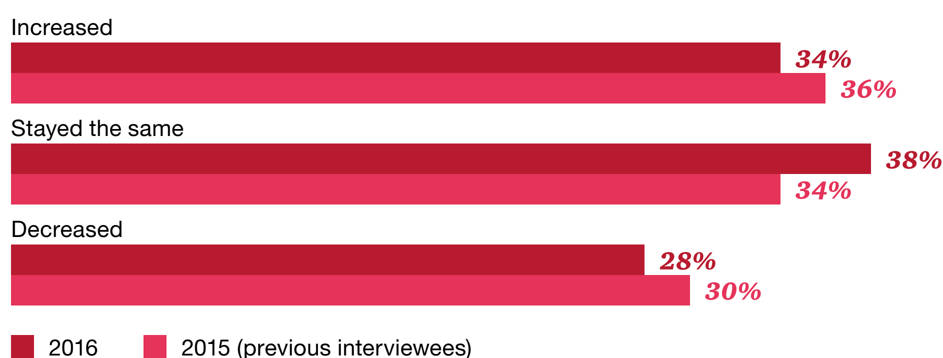
For some respondents this has made it hard to identify where to invest their capital. "Due to the volatile conditions and due to lack of growth there is a narrow range of returns that has made it very challenging to distinguish which targets are truly good for investment sake and which ones are the weaker ones," says a France-based managing partner. "The task of separating the strong performers from the weak ones has become difficult because we are not able to decide which companies we should back with future investments."

For others 2016 has been the year of increased opportunities and investment reviews, such as this Denmark-based partner managing a fund with AUM >€1bn: "We have increased our reviews this year as compared to 2015, because the conditions are likely to improve in the business environment and investments made now will facilitate considerably more returns in the long run which we are looking to capitalize on and hence are looking for suitable targets that have the potential to provide high returns."

And then again some are using the turbulent times to turn to their current portfolio and focus on its optimization. "Our investments have stayed the same as 2015. We are currently focused on leveraging the capabilities of our portfolio to increase our efficiency and management effectiveness and so are not getting involved in many new deals currently. Once we have optimized our portfolio businesses we will look to then make a new investment which is likely to be the case in 2017.", adds this UK-based CIO managing a fund with AUM >€1bn.

Looking for the exits

Fig. 20 Development in the number of exits compared to previous year



The picture on exits is more mixed. 38% say that the number of company sales was flat YoY, the result of fewer firms reporting an increase and decrease in exits compared with 2015. These sentiments reflected reality, with Mergermarket data showing that global exit value fell 4.7%, while volumes fell 3%.

Many reported that conditions, specifically pricing, were broadly similar and that the bid-ask spread prevented an increase in exits. "There has not been a major difference because of the pricing that was offered," says a partner in France. "There were sufficient buyers that came across, however the valuations didn't always meet our expectation."

The market shock in the summer of 2015 was still felt moving into 2016, with leverage hard to come by for larger, syndicated deals. However, by the second half of the trade and secondary buyers alike were willing to invest their capital on PE-owned assets. Indeed, the total value of exits in the second half of last year outstripped the first half by nearly 12%.

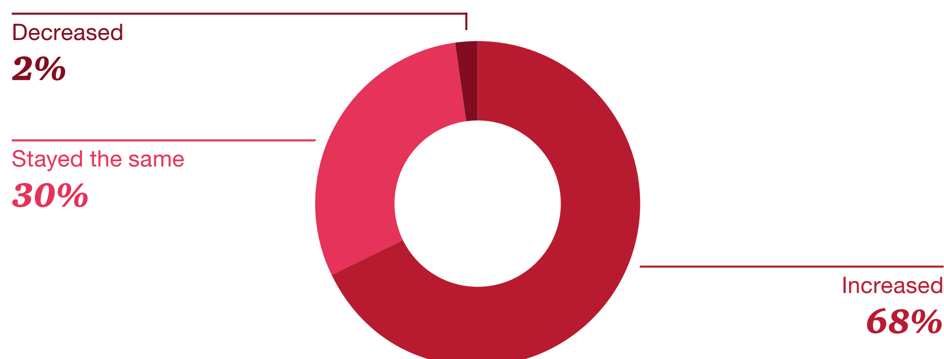
Some respondents report exits decreased slightly due to a correction in multiples in the market. "Business transformation activity has slowed down due to the rising economic concerns and political pressures and this has impacted our portfolio businesses which is why we have moved our exits slightly further in order to gain the returns we had expected to achieve by investing in our portfolio businesses." says this UK-based partner.

A crowded market

For a clear majority of firms the number of potential transactions reviewed in 2016 increased, despite a fall in the number of deals that respondents reported to have closed over the same period. For International funds, 68% say that their origination pipelines had increased. For German fund managers this rises to 73%, with only 3% saying that number of reviewed transactions decreased during the year. A Germany-based investment director confirms: "Our reviews for potential targets have increased considerably mainly as there are significant opportunities to invest in the current market, valuations are lower and regulatory structures have become lenient in order to attract more investors to the market and this is driving our demand for new acquisitions and investment opportunities."

Other respondents cited the difficulty in completing deals, the result of heightened regulation and competition from their own limited partners, as the reason for needing to review more potential transactions. "This year there has been a rise in the competition level due to the institutional investors showing extreme interest. Beside this the market has become all the more tempestuous and European government has made changes in their laws as well, making it difficult for the transactions to be performed and so more reviews are required so as to monitor the changes and impacts more closely," says a partner in Denmark.

Fig. 21 Compared to 2015, would you say that competition for investments among private equity firms has ...?

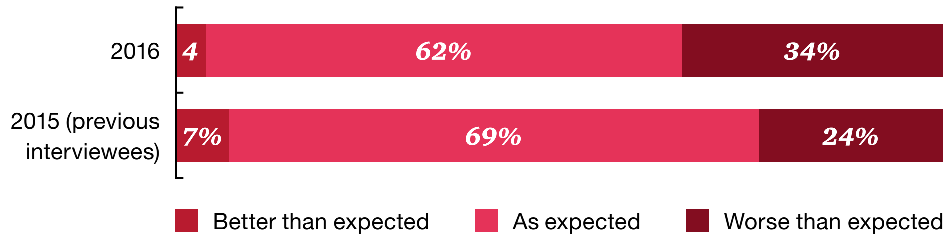


The private equity market has been highly competitive for some time, owing to an excess of dry powder raised in a favourable exit environment. For respondents, this is only increasing. 98% of respondents say that compared with 2015, competition amongst private equity firms for new deals either stayed the same or increased, with 68% reporting that it had risen.

This increased PE competition is coupled with the resurgence of trade buyers, who are taking advantage of an improved economic outlook and the stabilisation of capital markets to be acquisitive. "Competition has increased to some extent mainly because of the large amounts of surplus capital that many PE business have and the forward-looking trends of economic recovery," says one director of investment in Germany.

Credit on the cards

Fig. 22 Perception of credit for leveraged buyouts in the previous year



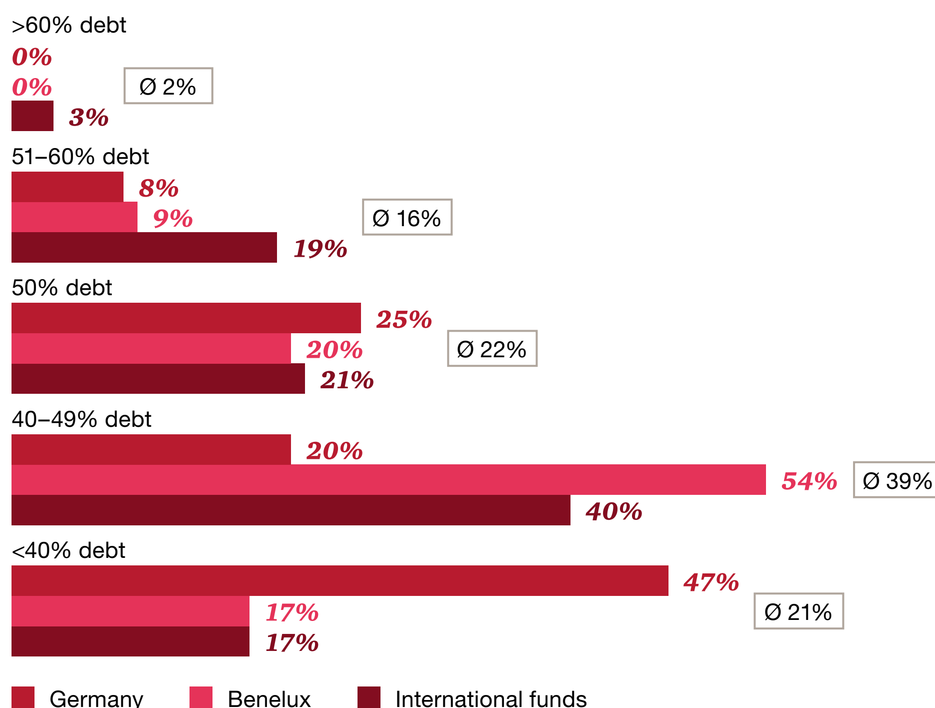
Despite a tough year, the perceived availability of credit to finance leveraged buyouts met their expectations. As much as 62% of those surveyed said financing conditions were as expected, with only 4% saying they were better than expected. A notable 34% reported that conditions were worse than expected, an increase of 10 percentage points YoY.

Last year was a mixed one for leveraged finance markets. While issuance did hit new peaks much of this was done to refinance existing debt rather than conduct leveraged buyouts. However, this did not stop some large deals in 2016, including Apollo's $6.9b LBO of ADT.

Many respondents mentioned that there were, nevertheless, challenges in the market throughout 2016. For some the year was divided in half as this Netherlands-based managing director shares his experience of the market: "The availability of credit for leveraged buyouts has turned to be better than what we expected it to be. There was credit available in the year 2016 more than what we expected, though it was low than 2015 but considering the volatile situation credit was still good. There were some LBO capital providers who held their capital back so as to make out how the first 6 months were and what were the challenges that were involved. Accordingly when they witnessed that there were less challenges and risks the availability of credit got better".

And you will know us by the trail of debt

Fig. 23 What was the average debt to equity ratio used by your organisation on new investments made in 2016?



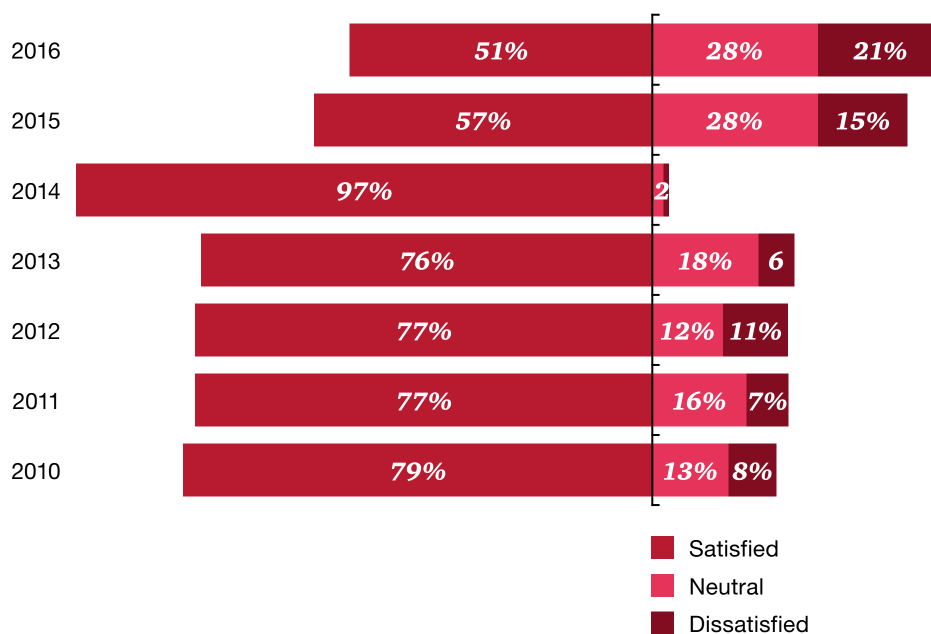
Leveraged debt markets may have resurged, but for buyout houses overall, there is a marked difference in the debt to equity ratios employed by firms in different jurisdictions. The results show that 22% of International funds use upwards of 51% debt in deals, compared with just 8% in Germany and 9% in Benelux. Notably, no German or Benelux funds used more than 60% debt in 2016, whereas 3% of International funds did. PE houses have turned more towards their portfolios and have been focusing on returns and this is reflected into their planned debt to equity ratios. "Our portfolio has been performing, we have managed to generate very strong returns, currently we have been generating enough capital to pay off our debts, we have focused on returns and this has helped us grow even though the market has not been growing that well.", adds a Germany-based managing director.

Conversely, as much as 47% of German funds used less than 40% debt and the sweet spot for 54% of Benelux funds is a debt to equity ratio of 40–49%. It is worth noting that German funds may be more conservative owing to local regulations which cap the interest deductibility of leveraged loans at 30% of EBITDA, which acts as a ceiling on leverage in many cases. However, a more conservative approach to leverage has not been untypical for German GPs, especially in volatile times like these.

Although economic conditions are more robust than initially thought at the beginning of the year, they are not so buoyant as to justify taking on high levels of leverage in 2016. As one German investment director comments, "Having a low debt to equity ratio is mostly preferred in times of distress and as we have been swung into such a situation where the economy isn't performing that well, we have considered a low debt percentage as the risks involved are too high and challenging to tackle."

Portfolio perspectives

Fig. 24 Level of satisfaction with the overall development of portfolio companies

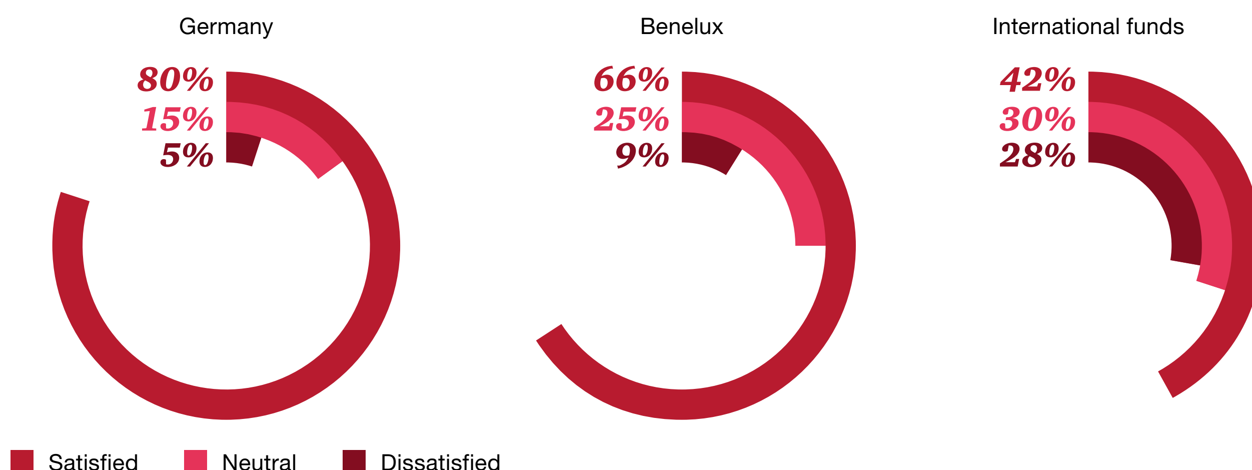


Fewer firms were satisfied with how their portfolio companies fared in 2016 than at any time since before 2010. Scarcely more than half (51%) say that they are satisfied with the development of their investee assets, a fall from 57% a year prior and a sharp drop on the 97% of firms who were satisfied in 2014. Similarly, 21% say they are dissatisfied, more than for any other year in the data. However, hand-on strategies have proven to be more successful, as in the case of this Germany-based investment director: "Through effective risk management and operational improvements we have managed to generate the value we expected in 2016 and have also opened new doors to opportunities that will further benefit our business in the coming years significantly."

A Netherlands-based partner confirms the success of this approach: "Looking at the overall performance level of our portfolio companies we are very well satisfied. There have been many changes what have been introduced by the management so as to achieve this expected growth rate. With constant monitoring we have been able to understand all the factors that we had to correct in order to enhance our performance which is what delivered the expected results."

However, there appears to be a disconnect between deal valuations and company performance amid a muted economic environment, an effect that is eating into returns. "We are neither dissatisfied not are we really satisfied with the performance," says a partner in Belgium. "The companies have not made losses but the profit margin they have currently is very small. Returns are lower than we would have expected."

Fig. 25 How satisfied or dissatisfied are you with the development of your portfolio companies in 2016? Would you say you are …?



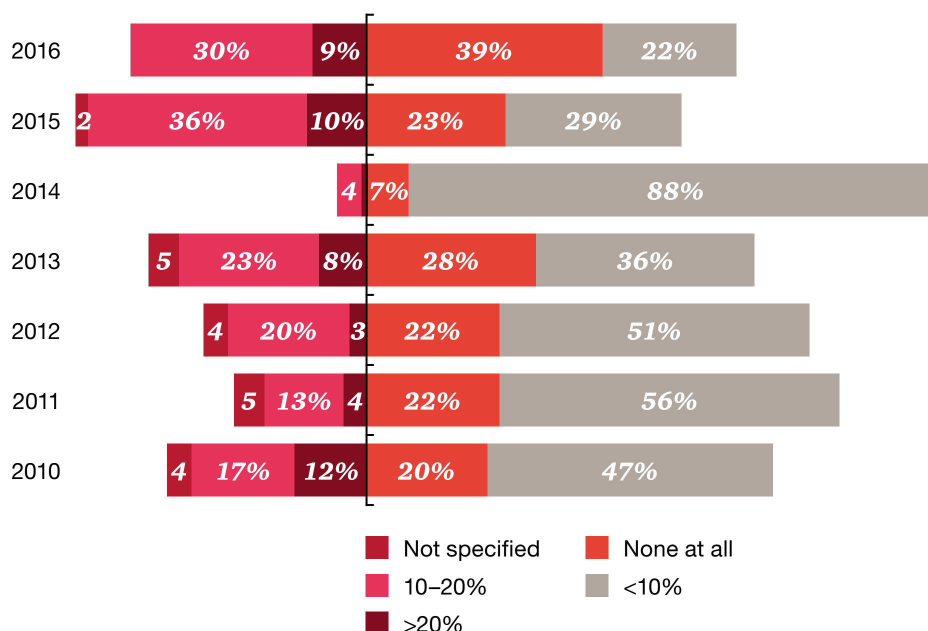
From a geographical perspective, German fund managers report higher levels of satisfaction with the development of their portfolio companies in 2016 than Benelux managers. The least satisfied are International funds.

A managing director from a Germany-based midmarket fund describes the sentiment in the German market: "We have been quite satisfied with the way our companies have been performing, there has been a decline in revenues but keeping the market conditions in mind our portfolio has not really performed badly, in the past our portfolio has performed better but we still feel it has been generating strong returns."

The expectations of international funds has been tempered by adverse macro conditions. "We are not dissatisfied with our company's performance, they have been to an extent impacted by the uncertainty in the market but overall our returns have not been low and we have been able to generate returns that has helped us grow and get returns which we have used to pay off debts," says an investment director at a British firm.

Fewer breaches

Fig. 26 Percentage of portfolio companies that experienced covenant breaches

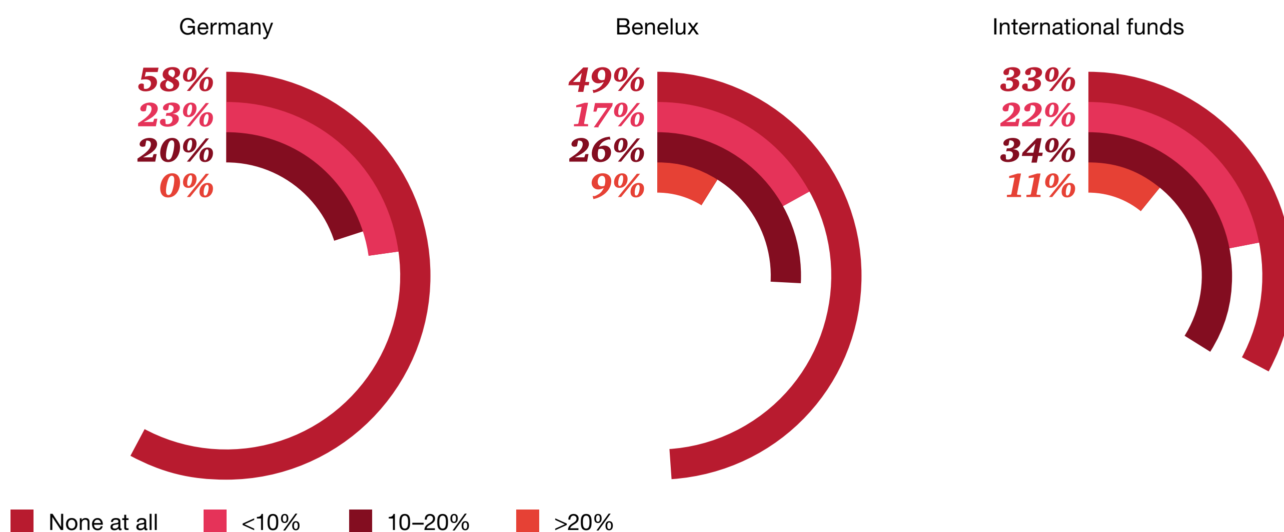


Reassuringly, companies in private equity ownership showed positive signs of managing their debt loads in 2016. For instance, 39% of this year's sample report no covenant breaches in their portfolio – the highest proportion since as far back as 2010. Further, only 22% say that less than 10% of their investee companies tripped debt covenants, also the smallest proportion over the same period.

This comes amid continued low interest rates in the UK and Europe and although the Federal Reserve increased the base rate in December it is still low at 0.75%. This makes servicing debt relatively undemanding and the figures indicate that, with the help of their financial sponsors, portfolio companies are maintaining sufficient cash flows to pay down leverage even as economic conditions remain sluggish. As one UK-based partner comments, "There was no requirement for our portfolio companies to break one or more bank covenants because we had already prepared our firms and there was a good and required amount of reserves already kept by our firms. There was constant monitoring done by our firm that helped us in handling the volatile times efficiently."

However, it's worth noting that covenant breaches in the 10%–20% range were found amongst 30% of firms, the highest proportion in all years dating back to 2010 except for 2015 (36%). And this being said, we should not forget that 2016 was very volatile in terms of political and the corresponding economical & stock market shocks have been difficult to manage or even foresee.

Fig. 27 Percentage of portfolio companies that experienced covenant breaches



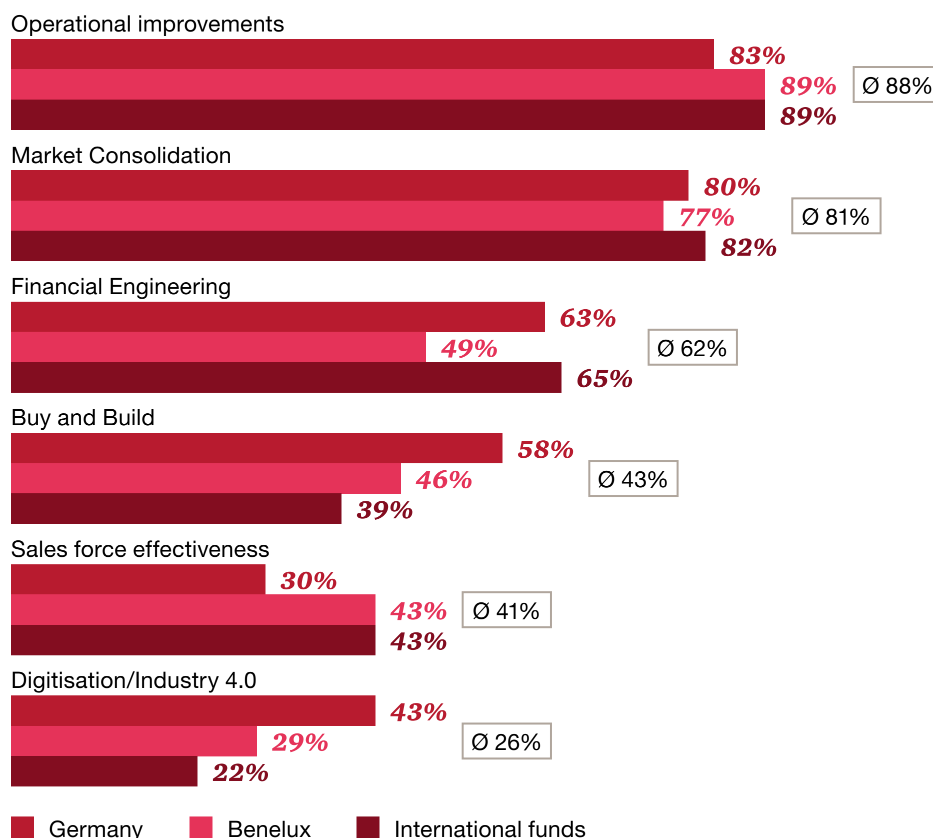
A higher proportion of German private equity firms report an absence of covenant breaches. According to our survey, 58% of firms in the country report that there were no breaches in their portfolio and none say 20% or more of their companies have suffered breaches.

By contrast, International funds are more likely to report covenant issues, with only 33% of firms saying that they have had no covenant breaches in their portfolios and more than one in ten (11%) reporting that more than 20% of their investee companies have breached banking agreements.

This broadly reflects the difference between German and international firms' appetite for leverage (see Fig. 23), with the former opting for lower debt to equity ratios, which on average would leave more headroom for maintaining standard financial covenants.

Home improvements

Fig. 28 Factors influencing investment rationale in 2016



For the majority of firms, operational improvements was the primary factor influencing investment rationales in 2016. The results match our findings from 2015, suggesting that operational improvements together with digitisation efforts will be a common priority in any upcoming given year. "Operational improvements are very essential at this time as businesses are facing tremendous pressures and it is the only way to stabilize the business and move forward. Adopting new technological tools into the system will help mitigate risk and will bring new growth opportunities to the table which will improve the business outlook considerably.," says a partner in the UK. For 89% of Benelux and International funds and for 83% of German funds, operational improvements are key.

The second most influential factor on investment rationales is market consolidation, which for 82% of International funds, 80% of German firms and 77% of Benelux firms was the main reason behind pursuing a particular deal.

There are many advantages to consolidating markets, such as increased purchasing power and the multiple arbitrage that can be gained from buying smaller competing companies to create a larger asset. Reducing competition is another benefit, says one investment director in Germany, "Consolidation is the best way to increase our portfolio business presence in the market. It also helps bring more efficiency to the business and helps avoid competitive pressures that are rising in today's business environment."

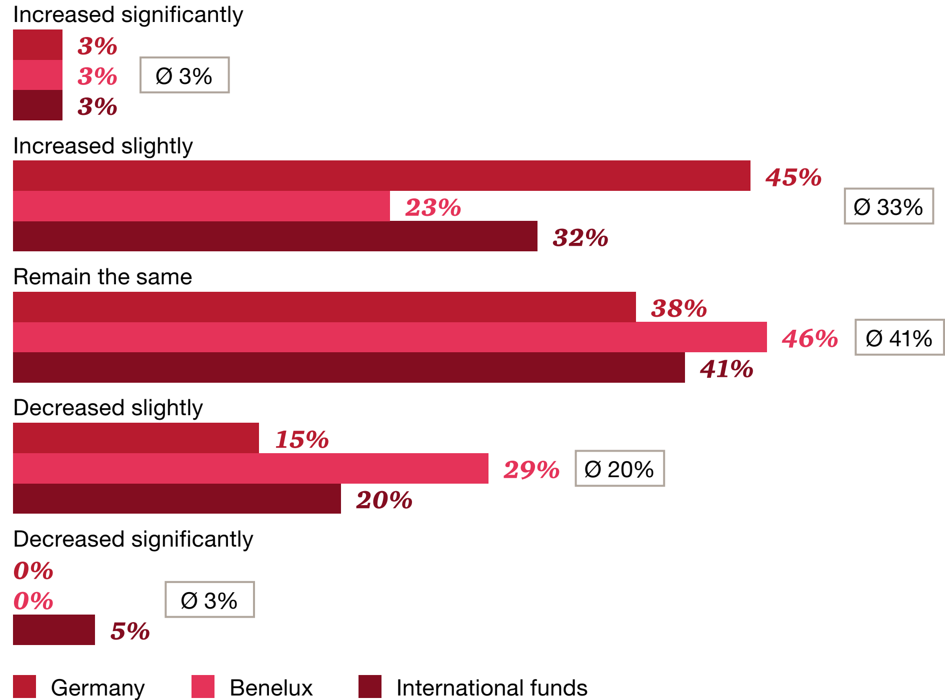
Buy-and-build strategies as well as investment rational based on the increasing digitisation of business seem to be mostly high up on Germanys agenda.
58% of German PE houses said buy-and-build strategies led their investment rationale in 2016, compared to only 46% of Benelux firms and even less – 39% by international funds. While sales force effectiveness is more important of a driver to Benelux and international funds (both 43%), German houses focus on digitising their businesses – 43% confirm it is an important factor in investment rational – compared to only 29% of Benelux funds and 22% of international funds.

Seemingly operational improvements and digitisation of business processes seem to be seen as integral to one another and the border between both is not clear cut anymore: "We want and need new technologies and need to adopt these so that our companies can perform better and reduce costs. We have been investing in and believe in automation and will continue in trying to develop our portfolio so we do use better technologies to make our portfolio operate better." Points out a Germany-based managing director of a mid-market fund.

"We have looked at the market and have realised that a majority of companies have been adopting new technologies to increase operational efficiencies and to make operations more successful and reliable. We invested in this to help us make large amounts of new technologies. We usually invest more in energy and real estate but we have altered our investment strategies to get returns." adds a UK-based partner of a >€1bn fund.

A bigger party

Fig. 29 Perception of change in the number of PE houses over the last three years



German firms are more likely to perceive that the number of private equity houses in the market has increased over the last three years, with 45% observing a slight increase. This falls to 32% for Internationals funds and just 23% for Benelux funds; indeed, a greater proportion (29%) of Benelux funds believe the number of firms has decreased than increased.

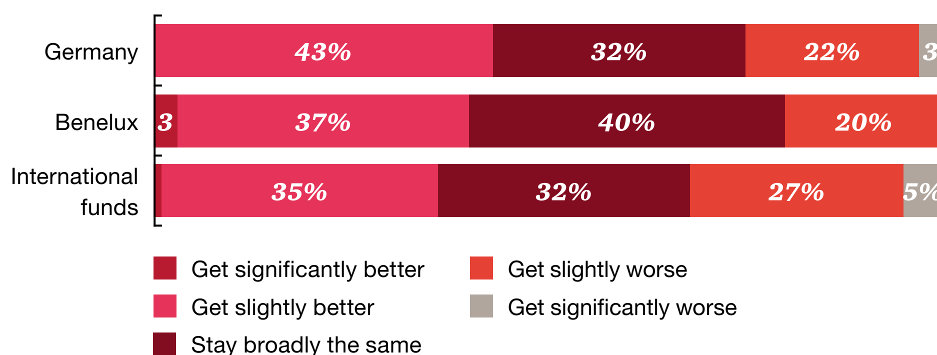
However, overall more firms believe that numbers have increased than decreased. This is to be expected. While there will be some degree of consolidation and rationalisation in the market, overall the asset class has delivered returns to investors. At the same time that the majority of firms successfully raise their next generation of funds, experienced dealmakers will break away and raise their own first-time funds.

"The number of PE houses has only been increasing. There has been an increase as PE managers have left their companies and joined new companies. This has been problematic and has increased competition significantly," says a UK partner.

2 The year ahead

Mixed picture on deal environment outlook

Fig. 30 Expected European private equity deal market developments



Firms are split on the outlook for private equity dealmaking in Europe. There is a slight weighting towards moderate optimism, with 37% of PE houses overall expecting the environment to get better. This compares with 26% of firms anticipating it to get slightly worse. Notably, German firms are more optimistic: 43% expect a slight improvement (35% for International funds) and only 22% expect a slight deterioration (27% International funds).

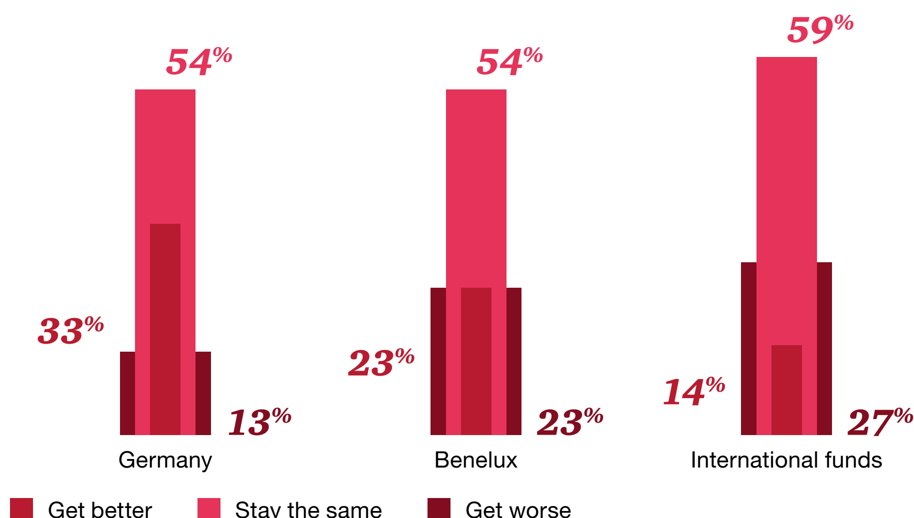
There is a high degree of political and economic uncertainty in Europe following the UK's decision to leave the European Union; with France, Holland, Italy and Germany holding elections in 2017, the future of the EU is in contention and the impact of potential disintegration on trade and investment is in question.

While some express their fears of geo-political uncertainties and their impacts on business and wider economics, others look hopefully into an even more promising year ahead. "With macroeconomic conditions improving there are defiantly high expectations that private equity would witness positive developments in 2017 because there would be more opportunities arising in 2017. However they would be limited ones as the conditions are improving only gradually. So this would trigger these positive developments, however, slowly but then it would assuredly be better than what was seen this year" expects a Germany-based managing director.

According to a partner in Germany, market volatility and sluggish growth has created demand for equity financing as companies struggle to repay debt. "The financial service sector has been impacted considerably in the past couple of years in Europe due to the uncertainties and constant market volatility, which has resulted in significant amounts of unpaid debt accumulating to even higher numbers. Hence the banks' ability to fund businesses in need of finance has reduced and the PE businesses have jumped to the opportunity, which is also getting sufficient government support." Indeed, PE's position at the forefront of alternative capital provision gives it a head start above other alternate lenders.

Cash flowing

Fig. 31 Expectations for availability of credit in 2017 compared to 2016



A clear majority of firms believe that the availability of credit will remain the same in 2017, with 58% of firms overall expecting no change. This is not a huge surprise as most of the respondents confirmed a very good and stable financing situation for their investments in 2016. And albeit the uncertainties and volatility that defined 2016, almost all reported high availability of credit to support leveraged transactions. "The amount of credit available for leveraged buyouts has been high this year. There has been a good amount of cash flow and this is expected to rise in future as well." Confirms a UK-based partner, managing a fund of above €1bn of AUM.

Once again, German firms are more optimistic than their Benelux and International counterparts, with 33% expecting an improvement and only 13% anticipating a deterioration. International funds are the most pessimistic, with only 14% predicting credit availability will get better and 27% expecting it to get worse.

Confidence returned to both equity and credit markets towards the end of 2016 as various political and economic unknowns were resolved. However, the question remains how Trump, Brexit and potential interest rate increases will affect private equity in the long run. "The challenges have definitely decreased and this has increased the confidence level of the capital providers in the market. Until there is a huge difference witnessed, we don't feel there would be a drop in the availability of credit for leveraged buyouts in 2017," says a managing director in the Netherlands.

Majority expect to increase number of new investments in 2017 compared to 2016

Fig. 32 Expected number of new investments in 2017

Most firms (52%) expect the number of investments they make in 2017 to increase, while a large minority (40%) believe they will stay the same. Only 8% expect completed deal volume to fall in 2017.

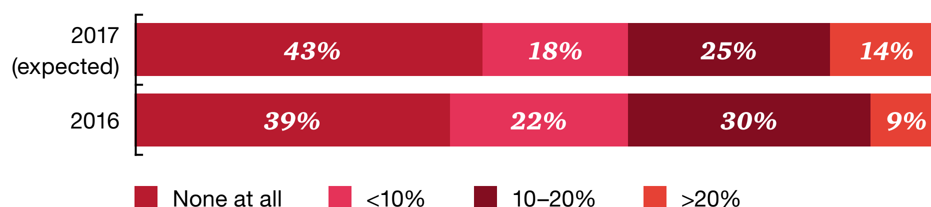
Buyout activity in Europe, and the UK especially, showed a marked drop in 2016 after the UK's decision to leave the EU. After 70 buyout deals in the UK in Q2 2016, for instance, this dropped to 69 in Q3 and then 57 in Q4. Across Western Europe as a whole, buyouts dropped to 550 in H2 2016 compared with 587 in H1. However, put in relation to the very successful and buoyant 2015, the slight dip should not be seen as reliable foresight. "The current market conditions are best suited for investments as valuations remain reasonable and the growth potential is significant because of the positivity seen in the economic climate, therefore we are very likely to increase our investments next year." says this Germany-based partner.

Given this decline, it is unsurprising that most respondents expect deal volumes either to remain the same or improve, particularly given that interest rates on leveraged financing remain low, economic performance is relatively robust (if sluggish), markets have stabilised and PE funds have dry powder to deploy.

"Despite all the problems what the European businesses are facing they have a strong potential to grow and expand which is what is paving way for new investment opportunities. Sectors like technology, retail and industrial sectors are planning to sign new deals and also looking for M&A due to which the number of new deal investments would increase significantly in 2017. The low rates of interest are contributing all the more," says an investment director in the UK.

Not breaking promises

Fig. 33 Percentage of companies expected to break one or more bank covenants



More than four-tenths (43%) expect no banking covenant breaches in their portfolio in 2017, a marginal increase on the 39% of firms who say there were no such breaches in 2016. There are further positive signs in that 43% anticipate up to 20% of their portfolio companies to break one or more of the covenants on their debt, compared with 52% who reported this level of breaches in their portfolio occurring in 2016.

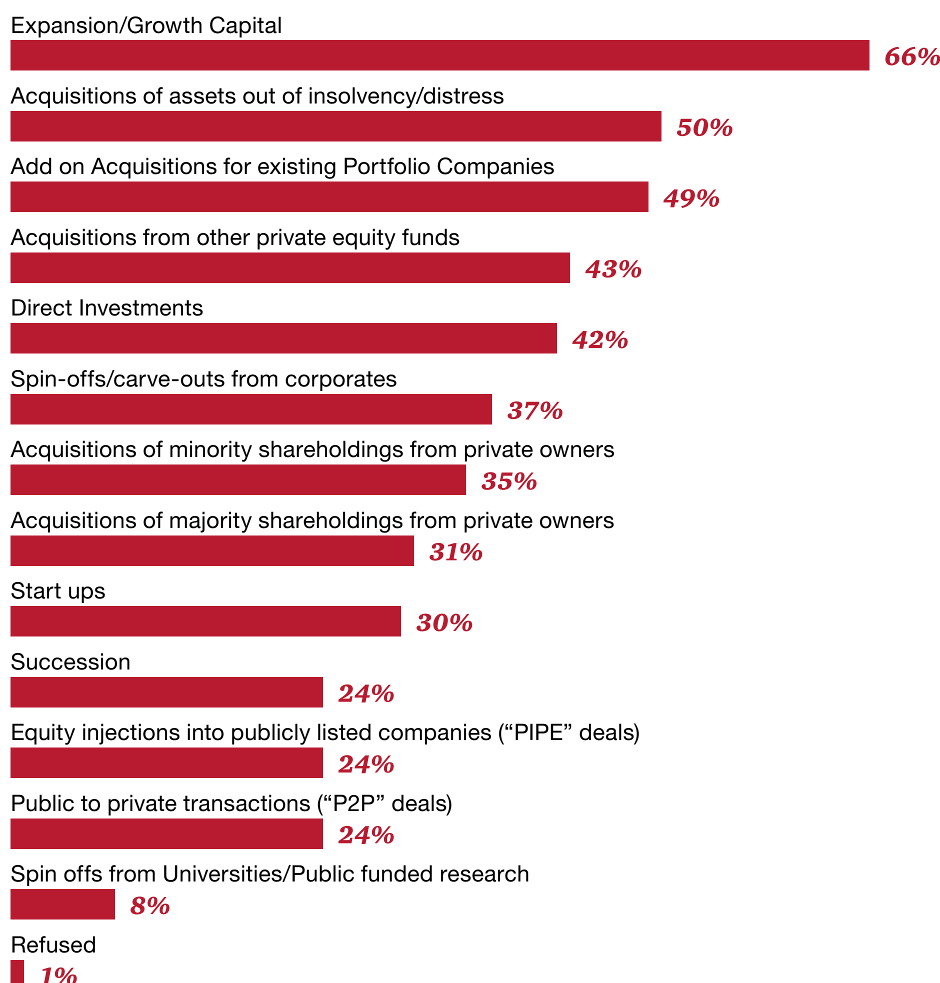
"We constantly monitor the markets and scrutinise changes and their potential impacts on our covenants. We have already considered the challenges for our portfolio firms and accordingly we have kept reserves to help them if necessary," says a partner in the UK.

However, it should be noted that for higher rates of covenant breach firms have a more pessimistic outlook – 14% expect more than 20% of their portfolio to break banking covenants, compared with 9% who reported this scale of breaches in their portfolio for 2016.

Nevertheless, good preparation, foresight and allowing for financial buffer seems to be the right way in times like these. This UK partner shares his funds way of managing to achieve no covenant breaches: "There was no requirement for our portfolio companies to break one or more bank covenants because we had already prepared our firms and there was a good and required amount of reserves already kept by our firms. There was constant monitoring done by our firm that helped us in handling the volatile times efficiently."

Buying for growth

Fig. 34 Which, if any, of these will be sources of new deal opportunities for your organisation in 2017?



When considering this year's deal pipeline, 66% of respondents cited expansion or growth capital as a source of transactions, making it the most popular. This matches last year's results. However, while acquisitions of assets of insolvency/distress ranked as the fifth most popular source of future deal flow in 2016, this has moved up to second place (50%) for firms in 2017. A close third is add-ons, with 49% of those surveyed saying that bolting businesses on to platform investments will be a source of new deal opportunities this year. 49% name add-on acquisitions for their current portfolio base as an important source of deals. This is in line with the popularity of buy-and-build strategies, mainly driven by market consolidation. Many confirm this strategy to be quite successful such as this Swedish investment director: "We will look to buy and build businesses as we are confident in our portfolio managers and have seen significant success in the past. Our portfolio managers have specialized skills in various industry segments and are extremely effective in assessing and mitigating risks which adds significant value to our returns."

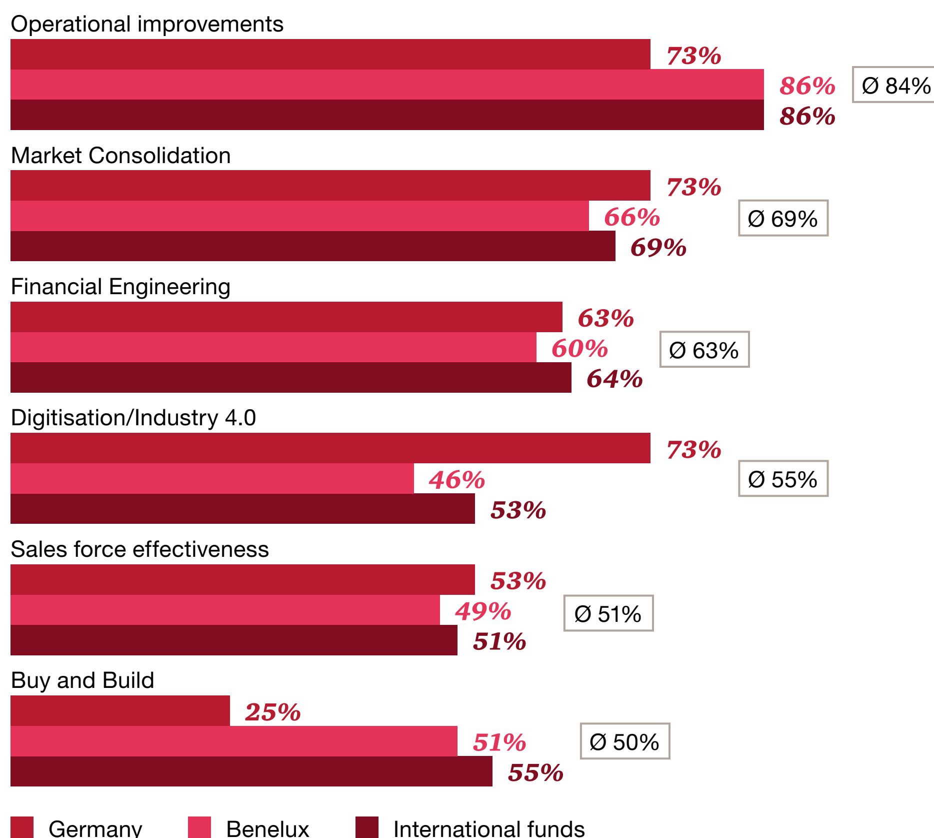
On the other hand, the PE world has still its eyes set upon the corporate world and expect the turbulent market conditions to force large corporations and conglomerates to focus on core activities and shed non-core operations. This is confirmed by this Finnish director investment: “Corporates are increasingly divesting their non-core assets at cheaper valuations as they want to sustain the core activities of their business and there are good opportunities to buy and link these assets to other businesses in our portfolio and so we will look to target more spin-offs from the corporate sellers.”

The emergence of distressed situations as a growing source of deal opportunities could stem from the high number of distressed companies seen in 2016. Indeed, according to Debtwire data, the number of levered companies with bonds and loans that are ‘either engaged in balance sheet restructurings or face imminent pressure to reduce debt’ rose from 399 in January 2016 to 454 in March the same year. Yet to immediately flag distress as a growing trend would ignore the fact that, on the whole, balance sheets are becoming healthier. In January this year, for example, Debtwire as registered just 248 distressed companies.

Another opportunity for investments PE houses see in the decline of the availability of traditional capital. “Businesses in the Europe are facing operating capital crunches and this is creating investment opportunities for us. The potential to grow is significant but the unavailability of funding from traditional lenders has reduced and this is creating significant investment opportunities for our business.” Says this Germany-based partner.

Investing to improve

Fig. 35 Main factors to influence rationale in 2016



Operational improvements are a common value driver for private equity houses and so it should come as no surprise that a majority of respondents (73% in Germany and 86% in Benelux and International) say this will be the main factor influencing investment rationales in 2017. And with anaemic growth in Europe, there is an emphasis on driving down portfolio company costs and improving margins.

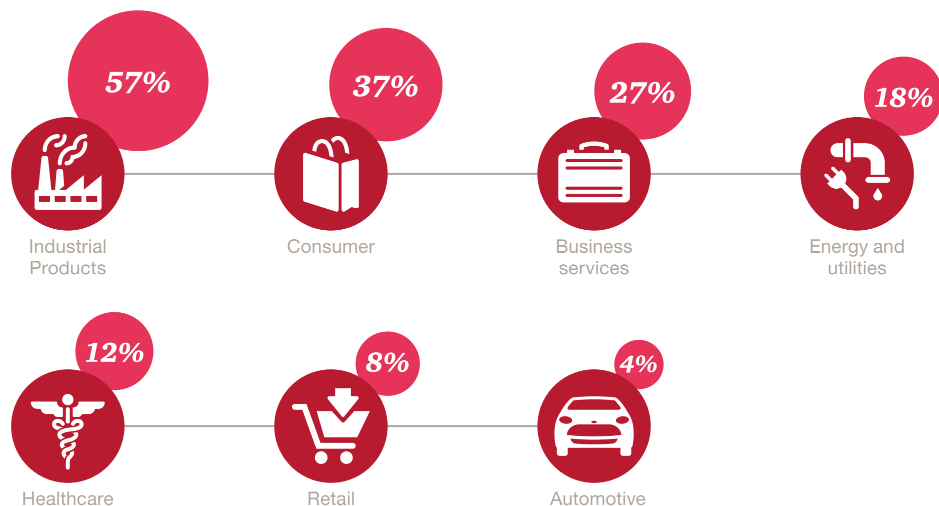
A partner in a UK firm explains why operational improvements are key: "Businesses are still suffering the negative consequences that have risen due to the uncertainties caused by the instability in the European political and financial environments and therefore to curb these business challenges we will focus on operational improvements, which will help us stabilise the business and prepare to deploy further growth strategies once the economic recovery gathers pace."

The second most popular factor influencing investment rationale is market consolidation (73% in Germany and 66% in Benelux and 69% International). Meanwhile, in Germany, digitisation/Industry 4.0 is just as crucial as operational improvements and market consolidation, with 73% of respondents citing it as a factor. This comes as the German government continues to promote the digitisation of industry, with €500m earmarked for public investment in industrial technology to give the country a competitive edge.

"I believe it would be only digitalisation that would make a huge difference because there are a lot of changes being introduced and companies are looking to adopt all digital changes so as to improve their skills, efficiencies and make them more competitive," says a partner in Germany. A Norway-based senior partner also confirms this view: "With the digitalisation growing rapidly there would be more companies that would be influencing the equity stories on acquisitions. We are looking towards making our companies more digitalised so that there are more growths attained".

The age of industry

Fig. 36 Expected target industries for future investment



Industrial production is showing the most demand from private equity firms over the next two to three years, with 57% of respondents citing it as a top target sector. This is followed by consumer (37%) and business services (27%). The results broadly reflect previous years' findings. Indeed, industrial production has been a favoured sector since 2010, but is forecasted to reach its absolute peak in 2017.

A German managing director explains the rationale along to the industrials focus: "We have heavily invested in automation and technology and will not change our investment strategies, we will go on investing in industrials and engineering companies, these companies have been generating strong returns and the demand for the products of these companies will not reduce."

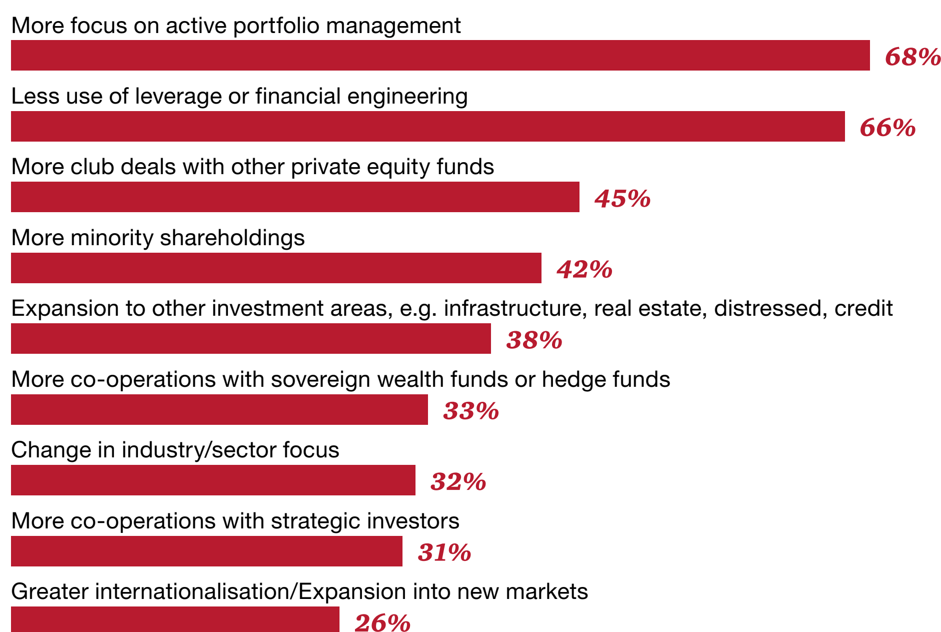
"Over the next two to three years we feel the IT, retail and industrial sectors will show more M&A volumes, may that be domestic or cross border ones. With the market stabilising, these companies are looking for expansion and if this happens then we would assuredly be getting more business," says a partner in Germany.

Attitudes towards healthcare have changed dramatically. As recently as 2013, the sector was joint most popular along with industrial production. However, only 12% of respondents now say they will target healthcare deals in the future, which speaks to the heavily regulated nature of the industry which makes it prone to changes in government policy.

Many, however, find technologies, irrespective of sector, in trend. "We want to go on investing in technologies, we have been able to generate a substantial amount even though the market has not been growing because we invested in diverse sectors. Our technology companies have gotten us a higher amount as compared to our other companies. We want to further invest in this sector to get higher returns in the future." adds a UK-based partner. This can be explained with the rapid digitisation of almost every area of business and life. PE houses have long recognised this trend, as confirms this Germany-based investment director: "We are looking to acquire technological businesses as the demand for their services and products are rising significantly. Businesses across various industry sectors require technological assistance and therefore the rising demand is creating investment opportunities for us as we are certain on achieving greater returns through this strategy."

Returning to action

Fig. 37 Which of the following changes, if any, have occurred to your organisation's business model over the last three years?



In recent years private equity firms have adapted their business models by focusing more on active portfolio management and less on leverage to drive returns. For 68% of firms, attending to portfolio management has been a focus, while 66% have concentrated on relying less on financial engineering. The global recession and ensuing slowdown in growth made it clear that leverage-based strategies were not viable in the long term, particularly through downcycles, and that firms must work more proactively with their portfolio companies to create value. On top of this, limited partners have become increasingly more vocal about concerns over PE, and have started to take a more active role whe it comes to co- and direct-investing.

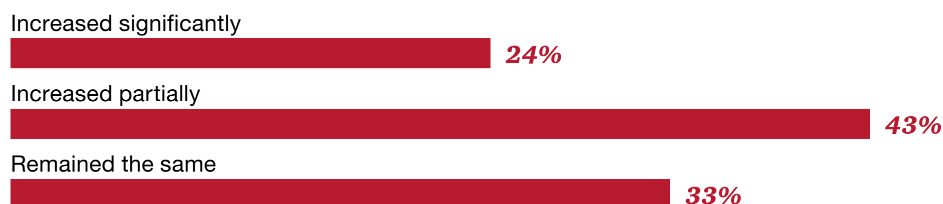
This is in line with previous years' findings. In 2015, less reliance on leverage and more focus on portfolio management were cited as primary changes to business models post-crisis by 80% and 68% of firms respectively.

A Luxemburg principal puts it to the point: "Actual portfolio management that is really a pro-active value creation that is what private equity is all about, this is something that is to be refined all the time. Financial engineering is more and more a commodity that's becoming less important and active portfolio management will remain important in the future as well."

For many the way out is by diversification, which has been a trend over the past years with the PE market in Europe becoming more and more mature and competition for assets growing each year. "We expended in to new markets and have changed our investment focus. We now invest in new sectors and are open to investing in different sectors, we have a very strong portfolio but we keep on monitoring it closely in case there are any changes in the market that will impact it.", explains this France-based managing partner. Similar strategies were confirmed by fund managers from Switzerland, Germany and the UK.

A new breed of LP

Fig. 38 Changes in expectations and requirements of Limited Partners (LPs) during the prior three years

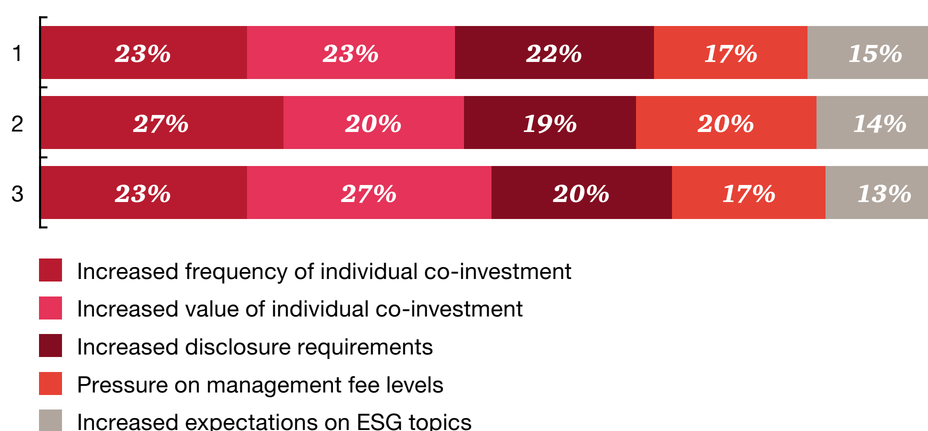


As much as 67% of firms have found that their LPs have greater expectations and requirements than they did three years ago. The majority (43%) of those say that expectations have increased only partially, with 24% saying they have increased significantly.

This comes as the LP community has become more sophisticated. For example, in an effort to standardise the market ILPA (the Institutional Limited Partners Association) has published due diligence questionnaires, limited partner agreements (LPAs) and standard reporting templates. This has placed a greater burden on GPs, who historically have engaged with investors on their own terms.

Despite LPs being more demanding, a partner in Denmark explains that managing expectations in terms of returns and portfolio performance is an important part of the investor relations process. “Expectations have remained the same as our limited partners understand the complexity in the market and are aware of the slow progress which is making the business performances unproductive and less profitable.”

Fig. 39 Top three changes in expectations and requirements from Limited Partners (where 1 = biggest change)



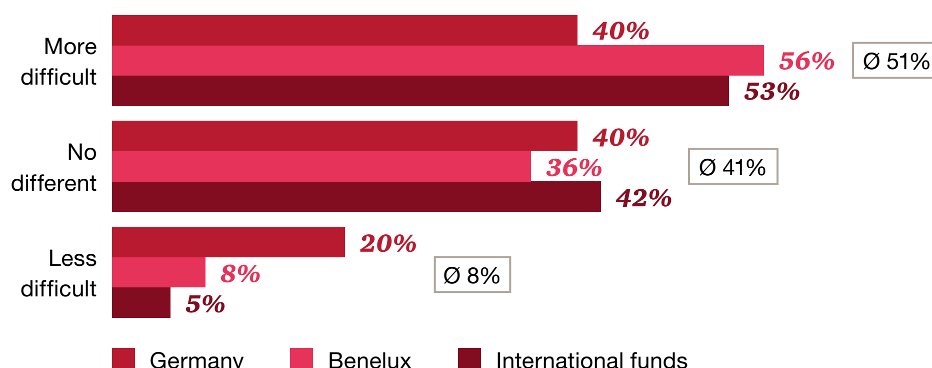
When it comes to specific changes expectations and requirements, the number one priority for limited partners is access to co-investment opportunities. For an equal proportion (23%) of firms, the biggest change to LPs' demands is both increased frequency and value of co-investments, a sign that investors are taking steps to reduce management fees and carried interest on at least part of their private equity exposure.

For a variety of LPs, from insurers to pension funds and sovereign wealth funds, investing alongside – or instead of – PE firms is becoming a much more popular strategy. The Canadian Pension Plan Investment Board, one of the largest such funds in the world, for example, invested $500m in Viking Cruises in September 2016, alongside US PE house TPG Capital. CPPIB is also bypassing PE houses altogether, as seen in its $720m acquisition of a 48% stake in software firm GlobalLogic this January. These are just two of a string of purchases the pension giant has been involved in since changing from a passive to active investment strategy in 2006.

Not far behind is increased disclosure requirements, which 22% of firms say is the biggest change to their LPs' expectations and requirements. Regulators have increased their scrutiny of how PE houses report to their investors, particularly how ancillary monitoring and deal fees are calculated and itemised, prompting heightened scrutiny from investors themselves.

Fund raising efforts

Fig. 40 Difficulty of fundraising – comparing most recent fundraising with prior funds



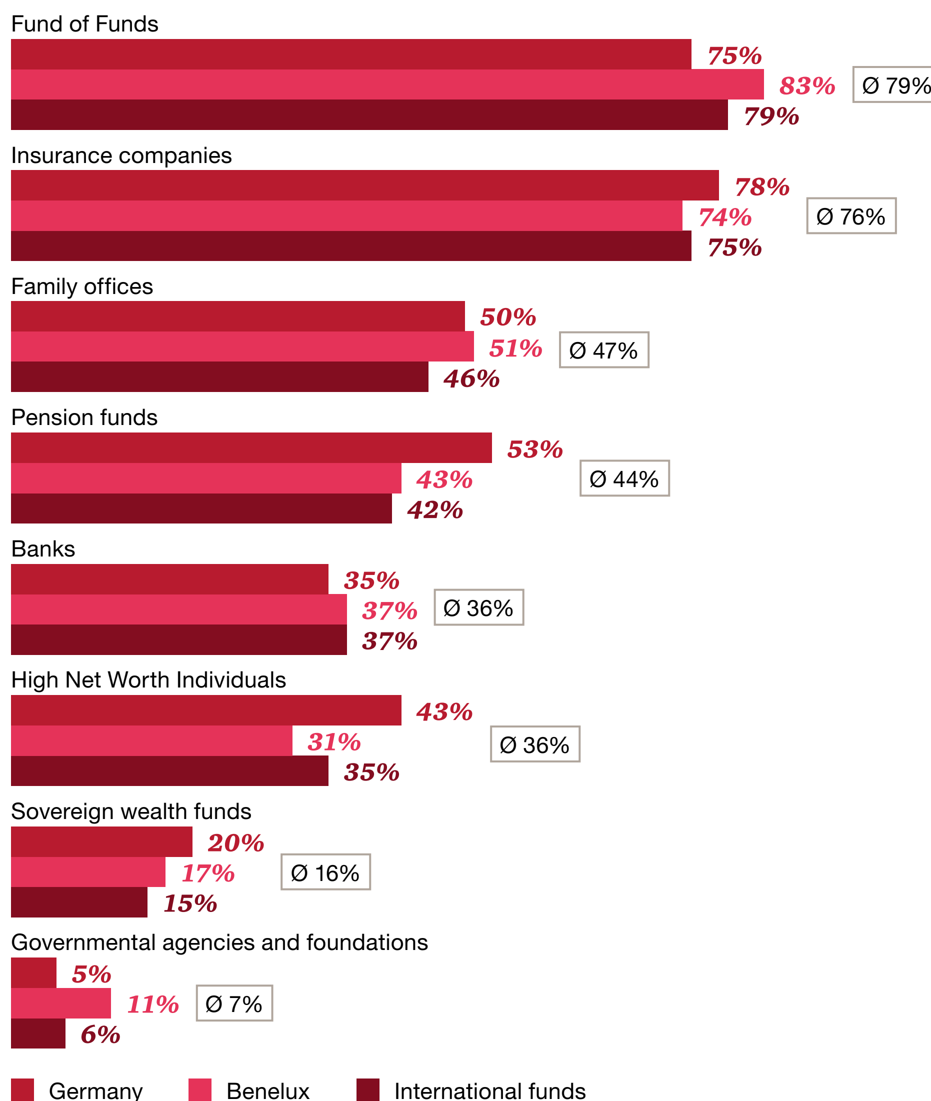
On average, firms found raising their most recent fund more difficult than previous efforts. Across all territories, 51% of firms that found it more challenging, compared with 41% who found it no different and 8% who say it was less difficult. Market volatility in the second half of 2015 and the first half of 2016 made raising capital harder. Indeed, according to Preqin, private capital fundraising globally hit just $131bn in Q1 2016, the lowest figure since Q2 2014.

"In 2015 there has been an increase in volatility that has impacted investors. Investors are less willing to invest their capital. We need to take help from external companies to increase our value and to get the amount we need," says an investment director in Finland.

Firms in the Benelux region found it tougher than other firms to fundraise, which can be explained by economic under-performance in recent years in the Netherlands, the biggest market in the region, which could dissuade investors from making fund commitments.

Future sources

Fig. 41 Expected investment partner contributions to future funds



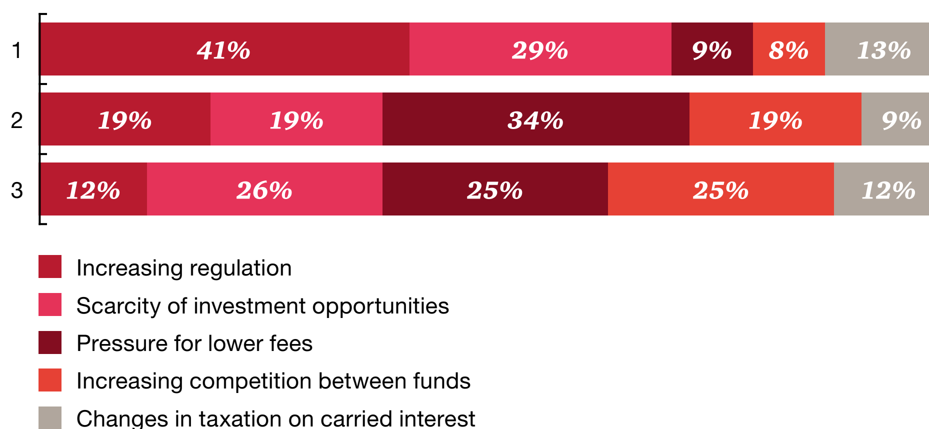
Funds of funds continue to be the primary anticipated source of capital for PE houses across all territories. Overall, 79% of firms said that funds of funds would be their chief class of limited partner in the future. Insurance companies are not far behind as the second most anticipated source of capital, for 76% of firms overall.

The results are encouraging. Solvency II regulation has made private equity investment more onerous and costly for insurance firms, however these results suggest that the returns promised by the asset class outweigh the regulatory burden. This does, though, create a weight of expectation that private equity must be committed to meet in the face of such challenges.

Going forward, there is less emphasis on partnering with high net worth individuals, who will be a top source of capital for only 36% of firms overall, slipping from 62% in 2015. At the same time, family offices are now expected to account for a greater source of funds; this year 47% of firms have marked such investors as a primary source of future funds.

The challenges ahead

Fig. 42 Top three challenges facing the private equity industry in Europe over the next 5 years



Considering the top three challenges facing the PE industry in Europe over the next five years, those surveyed are most concerned about increased regulation, cited by 41% firms as a number one hurdle. This is followed by a scarcity of investment opportunities (29%).

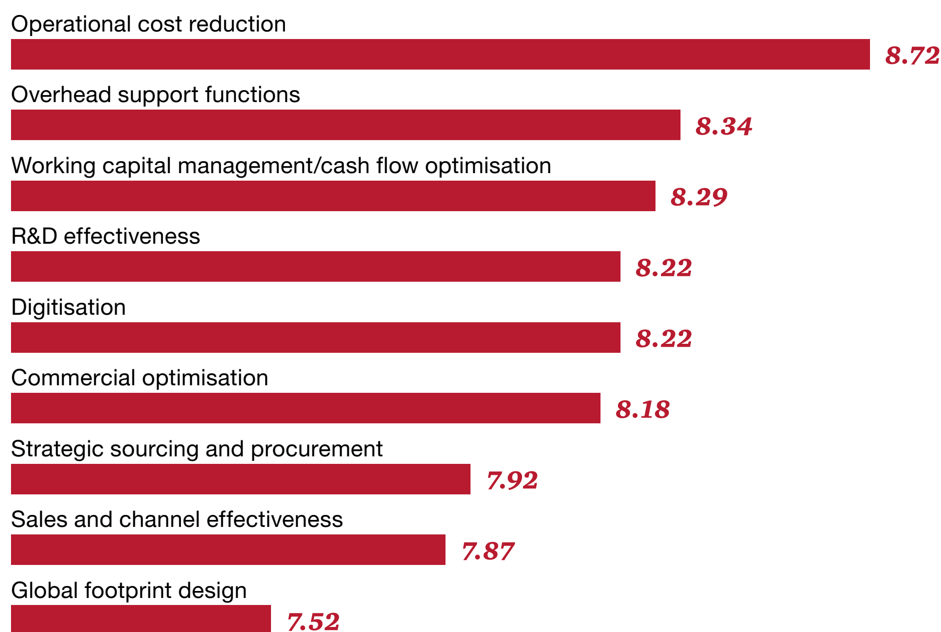
Followed by Solvency II's implementation in 2016, which put limits on certain fund investors, the coming year could also prove tough for PE regarding regulation. In the US for example, private equity funds could face increased taxes on carried interest, a plan outlined by President Trump on his campaign website. Uncertainty over the future of the Dodd-Frank Act, as well as the potential targeting of interest deductibility, also cast a cloud over future PE activity.

A secondary concern for 34% of private equity houses is pressure from LPs for lower fees. This has been an ongoing trend since the financial crisis and the LPs with the largest financial clout have been able to negotiate for more attractive terms. For the most part, the "2 and 20" fee structure still dominates and the best-performing managers will be able to dictate terms. However, lower quartile GPs may have to accept lower annual charges in favour of higher performance-related carried interest.

However, most respondents name "scarcity of investment opportunities" as the main issue facing fund managers and affecting the industry most. This Danish partner see the consequences of this in further diversification – be it in terms of sector or geography: "The availability of suitable targets has already reduced considerably and there are few potential businesses left in the market that suit the investment requirements of most PE businesses. This is going to further create scarcity of targets and the PE businesses will look to invest in new geographies as a result."

3 Focus on value creation

Fig. 43 Most important lever to value creation within the investment story



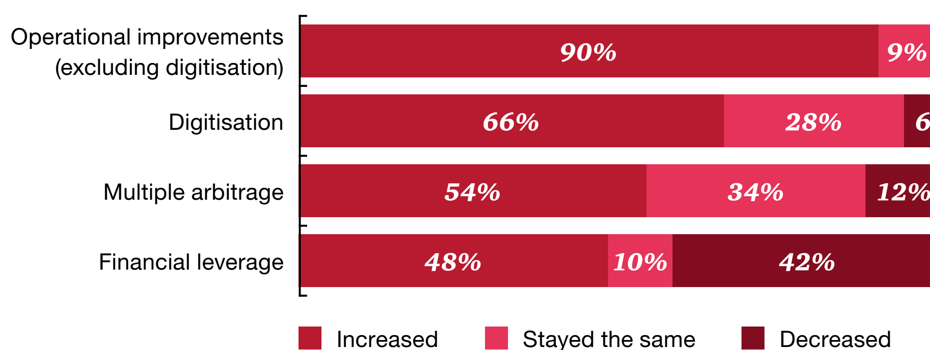
Operational cost reduction is the most important lever to value creation for PE firms surveyed. Given Europe's low growth environment, increasing sales may be more challenging than maintaining existing revenues and concentrating on boosting EBITDA margins through cost savings.

A number of other levers are ranked as important value drivers. Overhead support functions, working capital management/cash flow optimisation, R&D effectiveness, digitisation and commercial optimisation all scored above 8 on a scale of 1 to 10.

A partner in France explains how digitisation has impacted his firm's portfolio performance, saying, "We consider digitisation to be the main factor because this has helped in gaining the majority of benefits for our organisation. Also digitisation has increased the scope for growth more so than any other factor."

How digital will redefine PE

Fig. 44 Impact on return on investment of operational improvements, multiple arbitrage, financial leverage and digitisation in the last three years

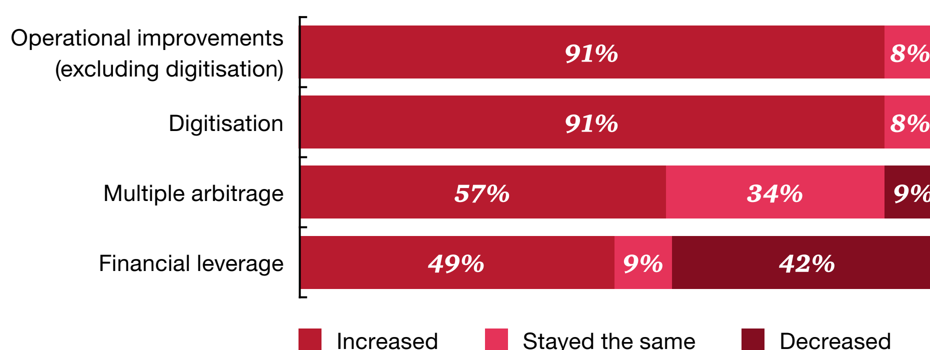


In the last three years the impact on returns of operational improvements has increased for an overwhelming majority (90%) of firms. Digitisation has also increasingly affected returns for 66% of firms over this period, as digital innovations continue to reshape industries, consumption and business models.

Once again we see that the digitisation has become an integral and inseparable part of operational improvements and hand-on value creation, which has become the main role of PE houses. "We have to an extent improved returns by improving our operations, we also used digital technologies to add to operational efficiency. We had to borrow capital and raise capital to help fund a few of our companies and to help them grow better." says a CIO from a Luxemburg-based fund.

For a substantial proportion (42%) of firms the impact of financial leverage on returns has decreased. Similarly, in 2015 32% of respondents said that the employment of debt in capital structures had had a decreasing impact on investment profits. In recent years, LPs have become more critical of funds' dependence on leverage and seek out managers who can deliver returns without relying on the ability of a portfolio company to repay debt.

Fig. 45 Expected future impact of operational improvements, multiple arbitrage, financial leverage and digitisation on return on investment

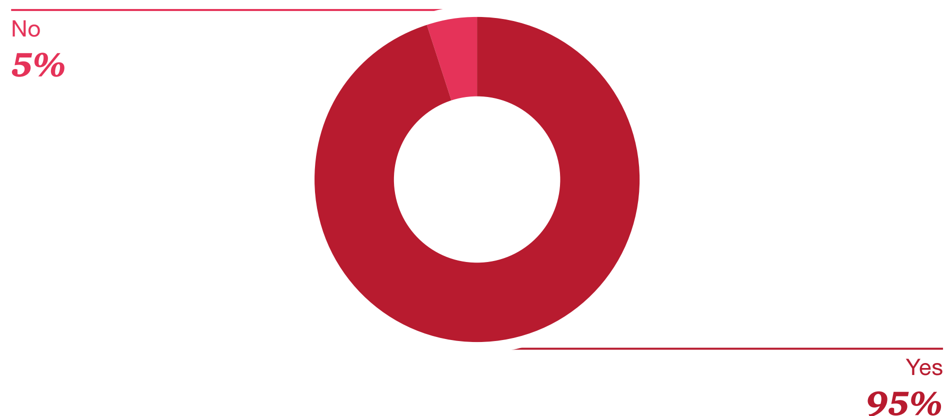


Looking ahead, the impact of digitisation on investment returns is expected to increase for 91% of firms. This will put this factor on par with the future impact of operational improvements, and demonstrates how PE houses are looking more closely at the value-creation benefits of improving technology in their portfolio companies.

Yet digital isn't the be-all and end-all, and clearly firms will rely on a number of strategies in order to deliver value. As one investment director in Italy says, "We use digital technologies and try to make changes in the company such that we can achieve higher value at the time we divest. We also leverage and borrow capital to make changes and improve operations to generate stronger returns prior to the sale."

Another managing partner from Spain adds: "In the future we feel digital technologies will impact our strategies and returns the most, these technologies once adopted will help us improve return and save on costs, it will make the whole process more efficient and will help our portfolio grow better while giving the management the tools to make better business decisions."

Fig. 46 Do you believe that digitising portfolio companies will speed up the realisation of the equity story and thus decrease the holding period of the portfolio?

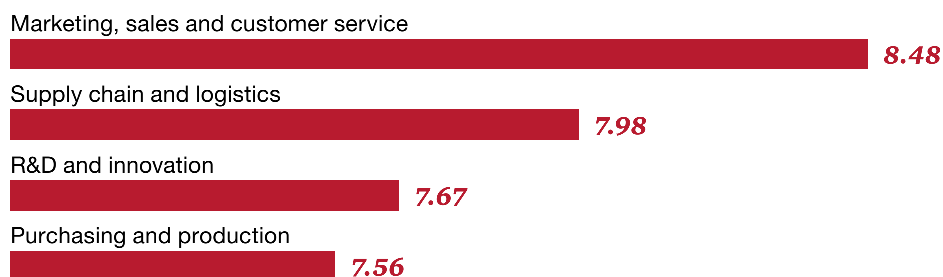


The march of digitisation is also expected to have a material impact on how long companies spend in PE ownership. According to 95% of respondents, digitizing portfolio companies will decrease holding periods by expediting value creation. "Buyers are more inclined to buy companies that perform well and are up to date with their technologies. Digital technologies do to a very large extent improve the deal and help attract buyers. Exiting from companies that use digital technologies has helped us reduce the holding period of a company," says an Italian partner.

This finding suggests that improving companies' digital capabilities will compound returns in two ways. First, greater efficiencies will accrue to businesses' earnings, making them more valuable at the time of exit. Secondly, shorter holding periods will boost time-weighted internal rates of return (IRRs) by distributing invested capital back to investors more quickly.

Fig. 47 Impact of digitisation

On a scale of 1 to 10, where 1 = impacted least, 10 = impacted most



Drilling down on exactly how digitisation is expected to impact businesses, marketing, sales and customer service is the function that firms believe will be most affected, as companies adopt ever more sophisticated CRM systems and service customers online, making them more efficient and competitive.

Digital technologies support efficiencies in many critical business areas, as this Italy-based partner points out: "Our supply chain and logistics is better managed because of digital technologies, we were losing a lot of capital in supply chain operations and needed to monitor the supply chain more closely. Digital technologies have also improved the way we interact with our customers, using digital technologies selling our products online and marketing online has had a positive impact on our sales." A Spanish counterpart adds: "A few of our companies have used digital technologies very successfully, we have managed to improve our R&D to an extent. Supply chains are optimised and we managed to reduce unnecessary costs that we were burdened with. Sales and marketing has been most positively impacted with us reaching out to customers online."

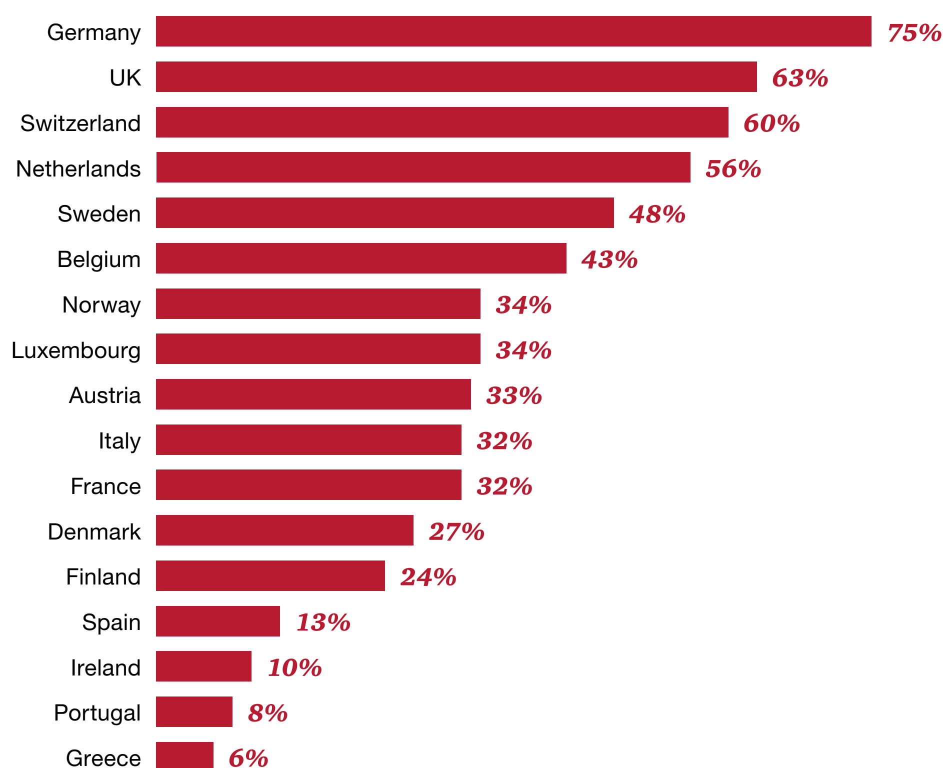
A number of vital functions are expected to be significantly impacted by digitisation, underscoring just how important it will be for PE houses to exploit the benefits of technologies in the coming years.

"All companies need to digitise if they want to remain in competition. Digital technologies are creating new avenues for businesses to operate in and are needed to improve operational efficiencies. Many businesses have adopted digital technologies and saved large amounts of capital on operations. We plan on making sure all our companies are optimised using digital technologies," says a partner in Belgium.

4 Global hotspots

As Europe struggles, Germany is emerging as a real contender for the continent's PE crown – while the US still leads the way globally

Fig. 48 Expected attractiveness of countries in Western Europe for private equity funds over the next five years



With so many macroeconomic and geopolitical factors redefining Europe through 2016, it is understandable that private equity would feel the effect. And looking into the future, many executives are seeing the bulk of interest swing further towards central western Europe.

German prominence

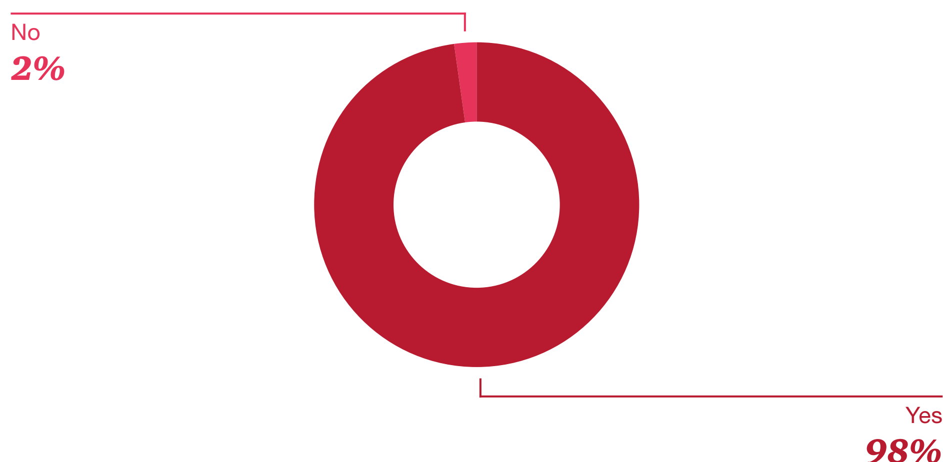
Germany is the most popular destination in Western Europe for private equity investment, with 75% of respondents identifying the country as attractive. This puts the country 12 percentage points higher than the UK, the next most attractive destination.

Germany may not have the most developed private equity market in the continent as measured by deal volume, but the country's robust economy presents a strong macro foundation for investors. Indeed, while the UK has seen greater PE buyout volume in every quarter since 2006, Q4 2016 saw 57 PE deals in the UK and 55 in Germany – narrowest gap on Mergermarket record.

A French investment director sums up the attractiveness of Germany by saying, "There is an abundance of companies in the German market for us to invest in, the market is growing at a very quick pace, there are many investors and getting capital is quite easy. The German market is very liquid. This will be good for us when we exit. Growth in the market is very strong and the market has grown despite the problems that have been affecting companies."

Germany's attractiveness comes as the UK looks to withdraw from Europe. While the UK has historically been the continent's largest private equity market in Europe, its attraction is waning in response to the country's decision to exit the EU, and it is still unclear how this will impact upon trade, investment and M&A.

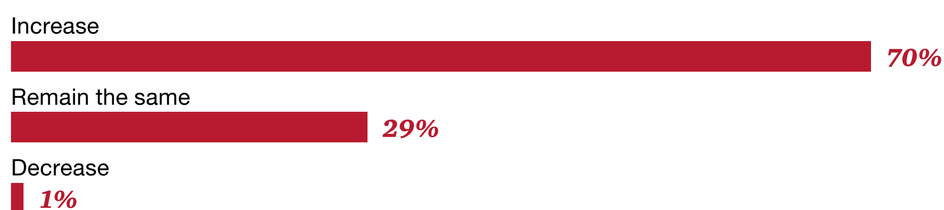
Fig. 49 PE houses planning on making investments in Germany over the next five years



Of those firms who already target the German market, nearly all (98%) say they are committed to making investments there over the next five years. Not only that, some houses that do not currently have any holdings in Germany intend to focus their efforts there in future, owing to its domestic growth profile.

"We have opened an office in Germany and want to tap into the German market. We feel there are many opportunities for us to invest in the market. Growth is not only strong but we also expect the returns from the market to be very strong," says one investment director in France.

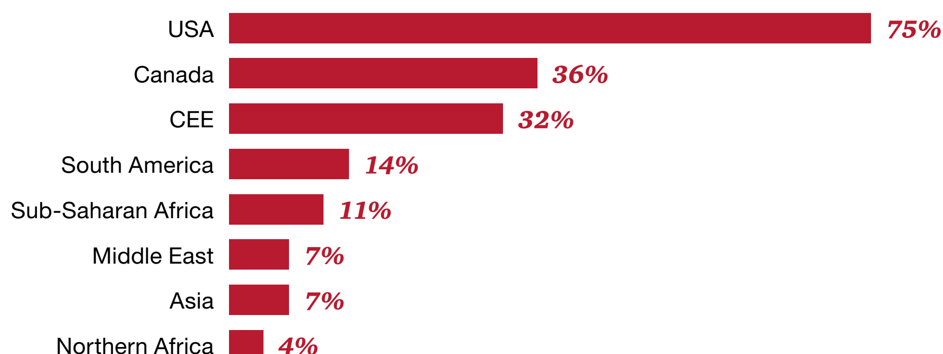
Fig. 50 Allocations of assets by PE firms to Germany over the next five years



With this growing confidence in the country, more than two-thirds (70%) of respondents believe that asset allocations to Germany will rise over the next five years. The UK and France have historically been the first- and second-largest private equity markets in Europe. However, uncertainty precipitated by the Brexit vote and weak economic growth in France have made the two markets relatively less attractive, to the benefit of Germany.

Developed markets rule

Fig. 51 Which countries or regions will become more attractive for private equity investments over the next five years?



Away from Europe, The US will be the most attractive location for PE investment over the next five years for 75% of those surveyed, putting it well ahead of any other region. By way of comparison, behind the US is Canada, which only 36% say will become more appealing over the same period.

The US has strong micro and macro foundations for private equity investment. As the largest, most liquid market in the world, debt financing and deal flow are plentiful. The US saw 987 deals in 2016, compared with 956 in 2015.

The country's economy is also performing well, with the Federal Reserve increasing the base rate to 0.75% in December, and the strength of the dollar versus all major currencies in recent years being a sure sign that investors have faith in the country's growth.

Only 7% say that Asia will become more attractive over the next five years. Despite China growing more strongly than more mature markets such as the US and Europe, its output has been trending down in recent years. Coupled with currency devaluations, this has given reason for PE funds to be less bullish about investing in the country.

D Methodology

In Q4 2016, Remark, the research and publications arm of Mergermarket, spoke to 250 private equity principals on behalf of PwC. Job titles include: partner and managing director. 16% of these funds are based in Germany and 16% in Benelux countries with the remaining 68% based elsewhere in Western Europe. Responses were anonymised and aggregated. All private equity firms of respondents had a minimum of €250m of assets under management.

Fig. 52 In which country your organisation's headquarters are based?

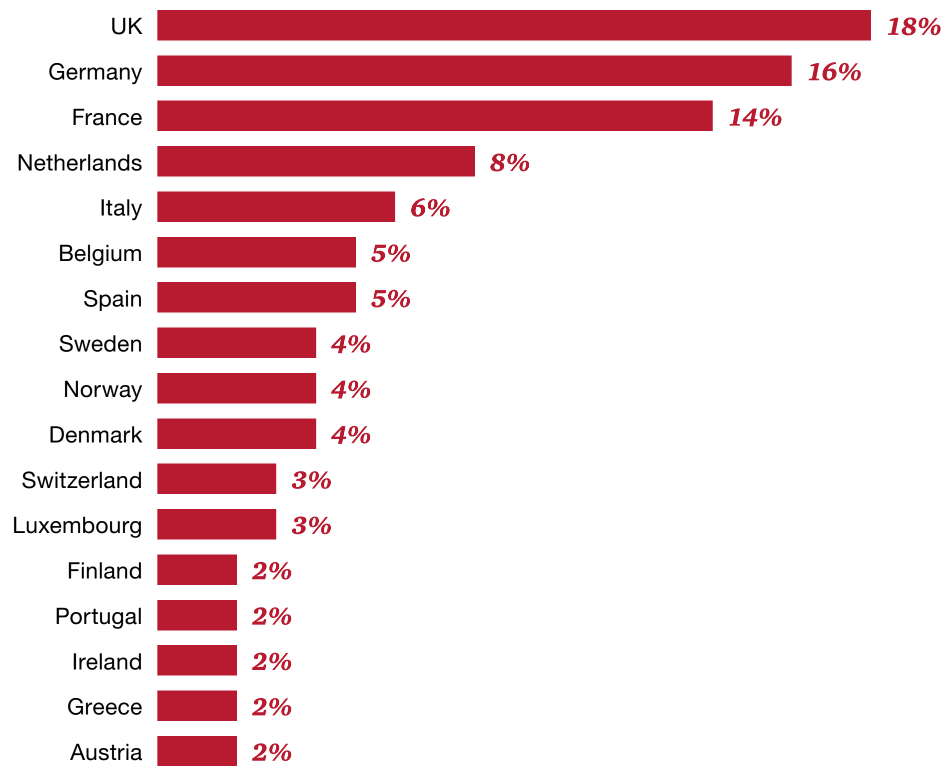
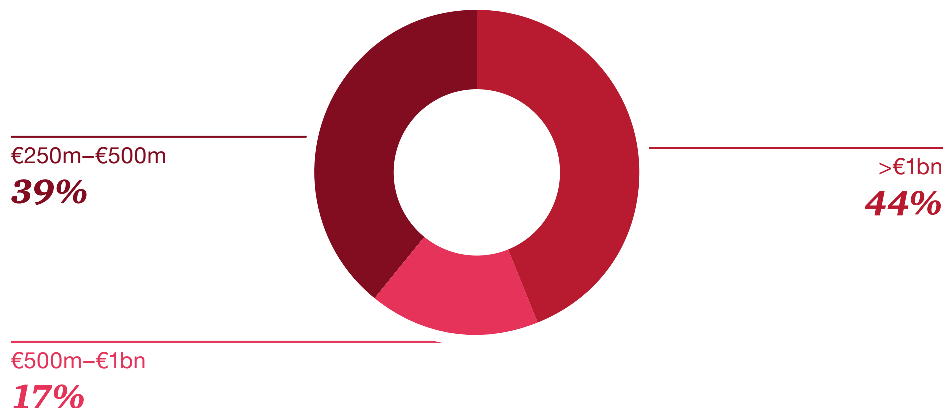


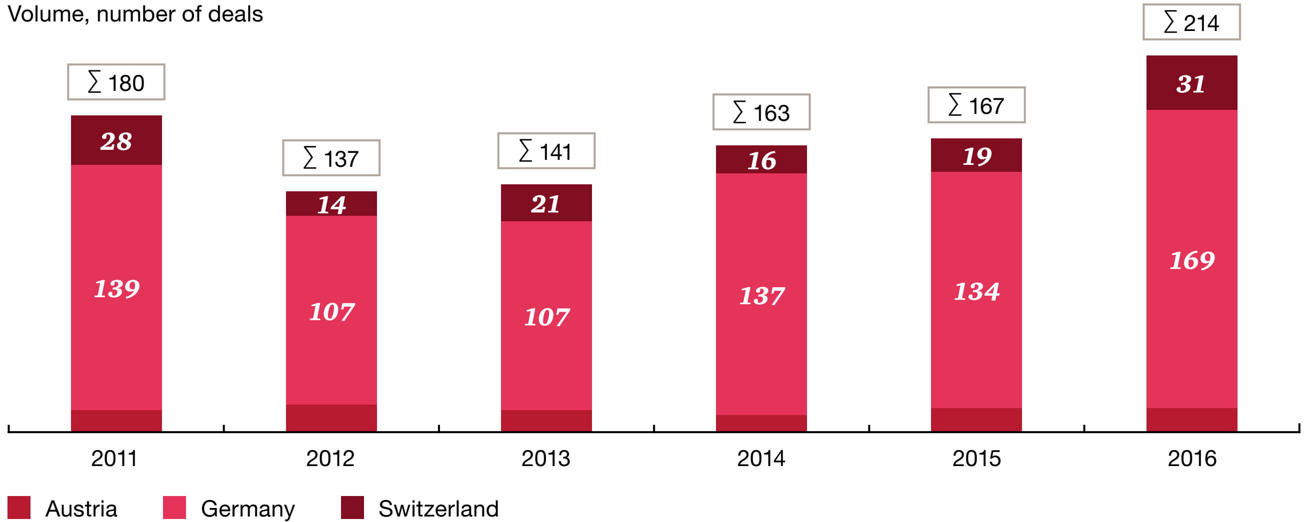
Fig. 53 Please could you tell me which of the following best describes your firm's current total global fund volume (i.e. capital under management)?



Appendix

Fig. 54 DACH Buyout Geography Split

Volume, number of deals



Value, €m

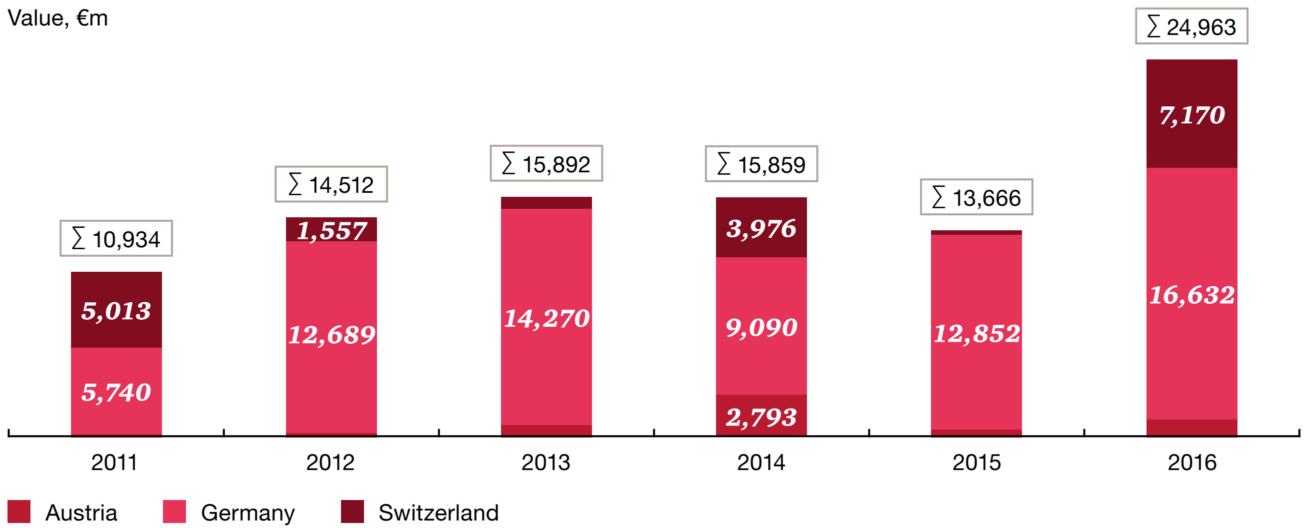


Fig. 55 DACH Buyout Deal Size 2011–2016

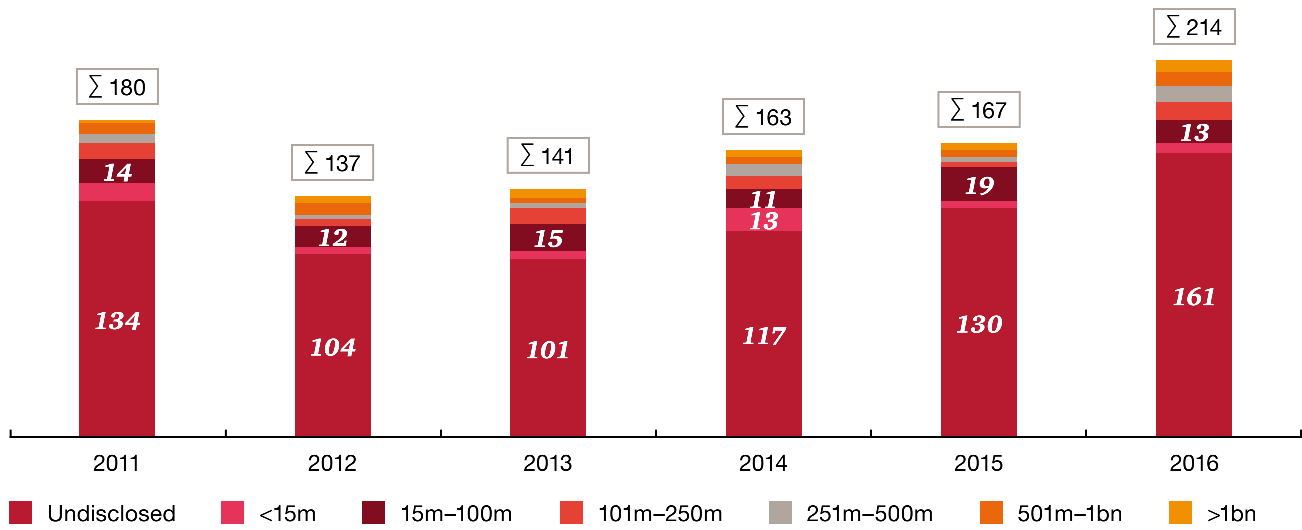


Fig. 56 Volume of deals by value brackets

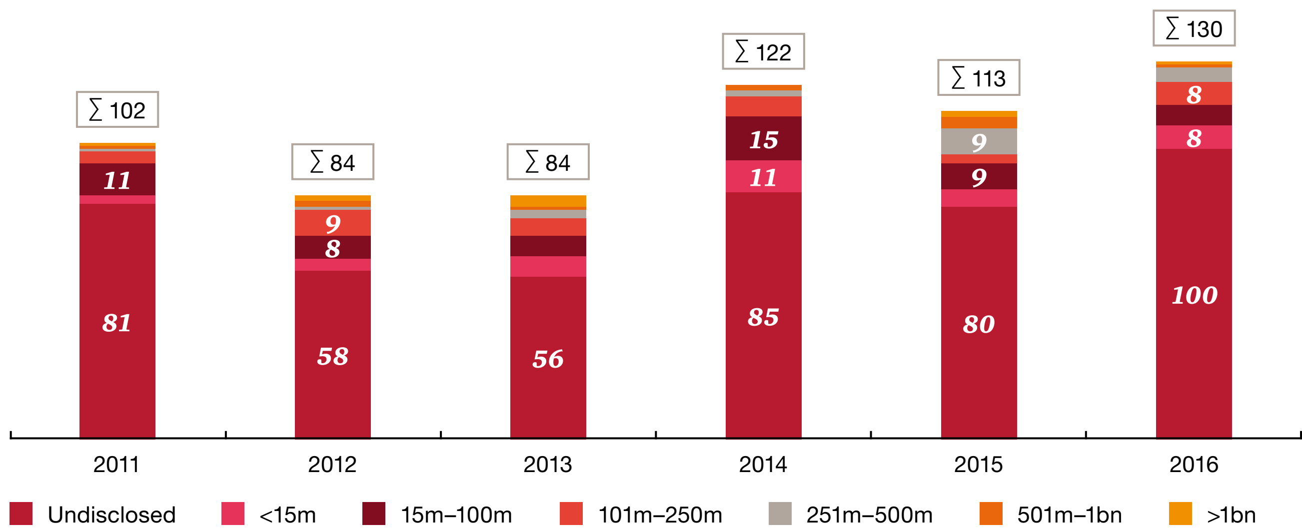


Fig. 57 Firstly, compared to 2015, has the number of potential transactions which you have reviewed in an average month this year …?

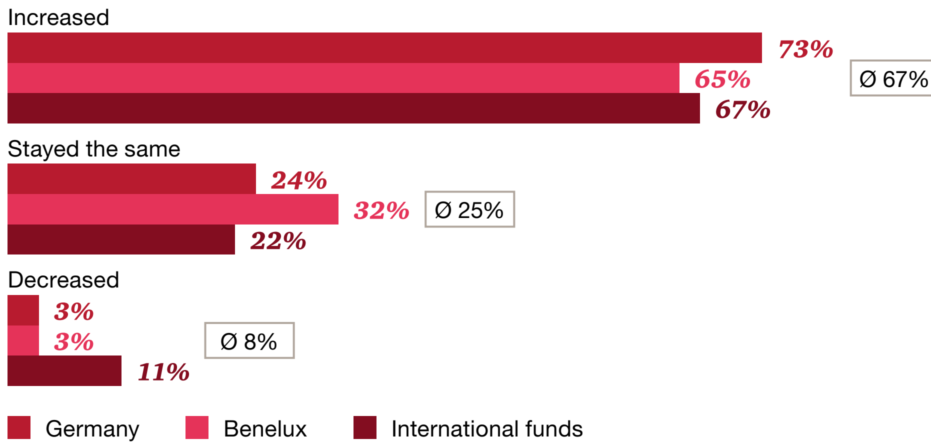


Fig. 58 Firms with current investments in Germany

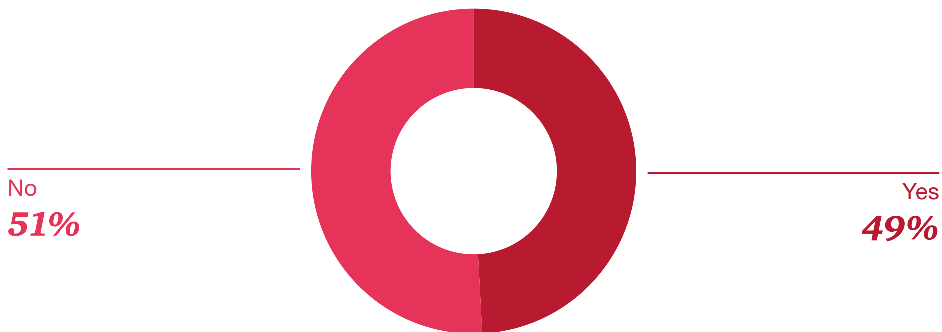
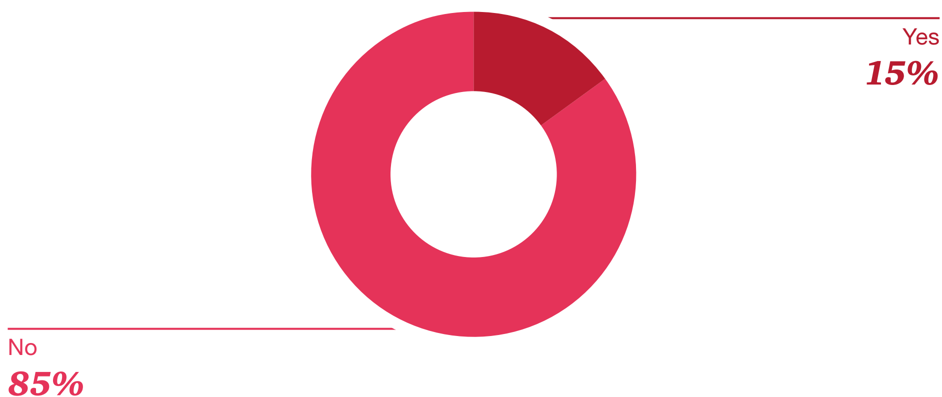


Fig. 59 Proportion of private equity firms planning to open offices in the next five years



List of abbreviations

AUM	Assets under Management
Benelux	Belgium, Netherland and Luxembourg
bn	billion
CEE	Central & Eastern Europe
CEO	Chief Executive Officer
DACH	Germany, Austria and Switzerland
EBITDA	Earnings before Interest, Depreciation and Amortisation
EU	European Union
GP	General Partner
LP	Limited Partner
m	million
M&A	Mergers and Acquisitions
PE	private equity
ppts	percentage points
Q1	First Quarter of the Year
Q2	Second Quarter of the Year
Q3	Third Quarter of the Year
Q4	Fourth Quarter of the Year
R&D	Research and Development
SEE	South Eastern Europe
UK	United Kingdom of Great Britain, Wales and Northern Ireland
US	United States of America
YoY	year on year

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