United Europe

SURVEY

Obstacles still remain, but Europe's private equity markets are becoming more integrated. Peter Cornelius *and* Karlijn Juttmann *of AlpInvest Partners look at the implications.*

Over the last few years, private equity in Europe has significantly gained in importance. Playing catch-up with the US, investment-to-GDP ratios have increased in virtually every member country of the European Union, and in some economies they have doubled or even nearly tripled between 1999 and 2006.

Totaling more than €71 billion ($104 billion) in 2006, investments in European buyouts and venture capital averaged almost 0.6 percent of GDP, up from 0.3 percent at the end of the last decade (see figure 1). Private equity funds have grown significantly in size, allowing GPs to target considerably larger deals with a rapidly rising share of the European M&A market.

While turmoil in the credit markets substantially dampened the volume of European (as well as US) buyouts in the second half of 2007, both supply and demand fundamentals suggest that the longer-term growth potential remains considerable.

As we discuss below, the growing significance of private equity in Europe has been accompanied by three fundamental trends: (1) increased market integration within Europe; (2) growing global integration, especially with the US; and (3) rising concentration in financial intermediation. These trends look set to gather further momentum as the European private equity industry continues to expand.

1. MARKET INTEGRATION IN EUROPE

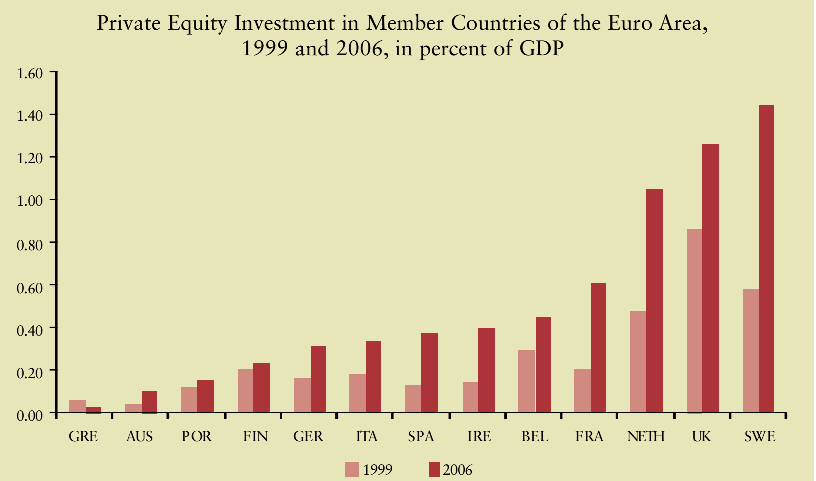
Capital flow data

Generally speaking, assets with identical risk and return characteristics should be priced identically in fully integrated financial markets - regardless of where they are transacted. An example is the euro interbank deposit market where the cross-country standard deviation of the average overnight lending rates among euro area countries has decreased to just one basis point since the introduction of a common currency in 1999. Similarly, in the euro corporate bond market, the country of issuance has become of marginal importance in explaining yield differentials.

Progress towards an integrated market depends on the broadening and deepening of cross-border financial links. In order to examine the degree to which the European private equity market is integrated, we employ data collected by the European Private Equity and Venture Capital Association (EVCA), which allow us to distinguish between the geographic location of the GP (country of management); the geographic location of the limited partner (country of origin); and the geographic location where funds are deployed (country of destination).

Although the EVCA database comes closest to what we are interested in, it is not without limitations. First, the data makes no distinction between different investment stages, preventing us from examining the degree to which individual segments of the private equity market - notably buyouts versus venture capital – are integrated. Second, as far as cross-border fundraising within Europe is concerned, no breakdown of individual countries is given. Therefore,

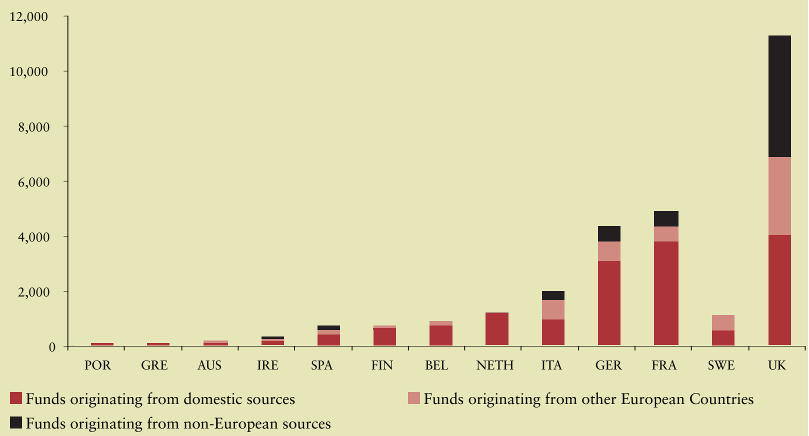
FIGURE 1



Source: EVCA

FIGURE 2

European Fundraising Flows, 1999 (€m)



Source: EVCA

we are unable to say to what extent integration in the euro zone might have been subject to different dynamics compared with economies that have decided not to adopt the euro.(1) Third, no data is available with respect to non-European funds investing in European companies. Finally, there is no information on European LPs' commitments to non-European funds. Notwithstanding these important limitations, a number of interesting observations can be made:

Fundraising

An important indicator of market integration is the degree to which domestic private equity funds rely on commitments from domestic investors. As far as the 13 member countries of the euro area are concerned, 72 percent of the €13.6 billion raised in 1999 was attributable to investors domiciled in the same country. By 2006, this share declined to 67 percent, a drop entirely explained by the relative increase in the share of LPs based in other European countries.

Whereas GPs' reliance on domestic investors in the euro zone still remains quite high, LPs show a significantly more pronounced decline in their home bias. Their investments in funds managed by GPs in other European countries (including those outside of the euro area) rose by 380 percent between 1999 and 2006 - substantially faster than the 60 percent increase in commitments to funds managed in their home country (see figures 2 and 3).

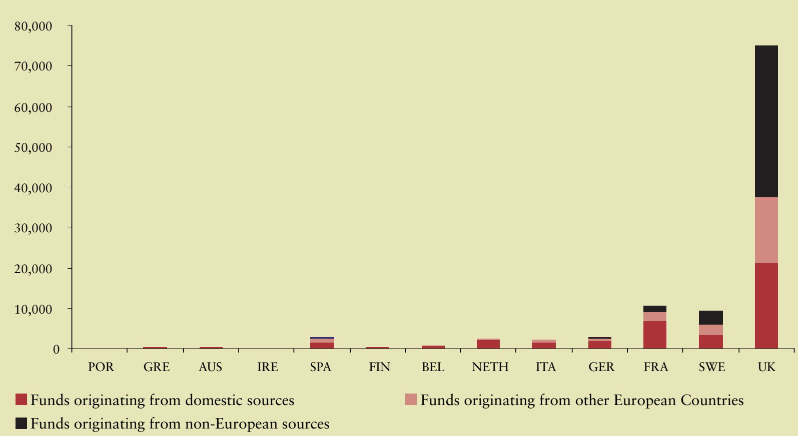
The main beneficiaries were funds managed by GPs domiciled in the UK, whose role as Europe's major financial hub has become even more dominant in recent years. That the UK decided not to adopt the euro seems to have had little, if any, impact. As funds have largely been raised in euros, there is no currency risk for euro area-based investors. In part thanks to the strong increase in cross-border flows from other European countries, GPs in the UK were able to almost double their share of fundraising to around two-thirds of the European market between 1999 and 2006.

Investing

Turning to the investment side, the overwhelming share of funds raised by GPs in individual countries in the euro area is invested in the same country. As a matter of fact, domestic GPs in the euro area have become even more home-biased in recent years, with the share of funds going to domestic companies having increased to almost 88 percent in 2006 from 82 percent in 1999. By contrast, cross-border investing by UK funds has risen substantially, further underlining the UK's role as a financial hub. Of the €41 billion invested in private equity deals in 2006, around €18.5 billion was deployed in acquisitions abroad, mainly in other European economies (€16.1 billion). By comparison, domestic acquisitions still accounted for 75 percent of the €11.5 billion of

FIGURE 3

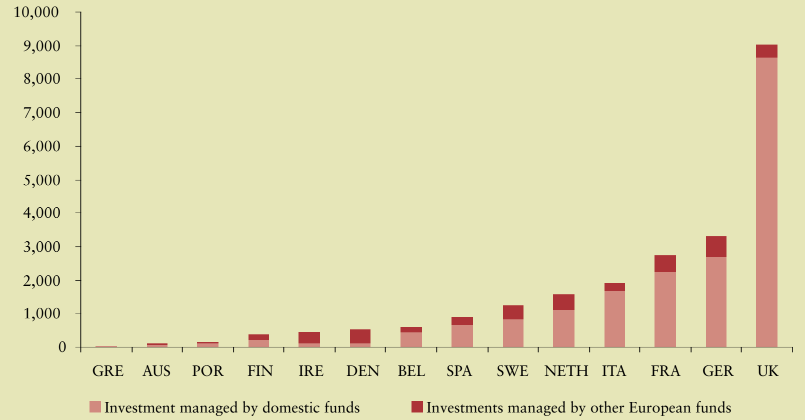
European Fundraising Flows, 2006 (€m)



Source: EVCA

FIGURE 4

Private Equity Investments in Domestic Companies by Domestic and Other European Funds, 1999 (€m)



Source: EVCA

investments made by UK-based funds in 1999.

What does the picture look like from the standpoint of European portfolio companies? In 1999, firms acquired by financial sponsors in the euro area received total financing of €12.6 billion. Of this amount, €9.5 billion represented investments made by funds domiciled in the same country as the portfolio company (see figure 4). The remainder (around one quarter) was due to acquisitions made by foreign funds. These include funds domiciled in other (euro area and non-euro area) European countries as well as non-European economies. In 2006, domestic and foreign investments in euro area portfolio companies totaled €35.8 billion, an almost threefold increase since 1999. Domestic investments contributed comparatively little to this increase. Instead, the key driver was cross-border investments, which increased nearly six-fold to €14.5 billion (see figure 5).

2. EUROPE'S GLOBAL INTEGRATION

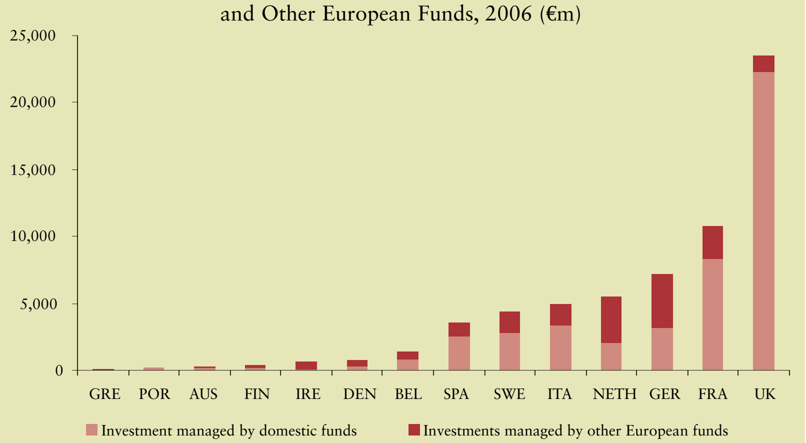
A country can integrate with the region where it is located or with the world as a whole. As far as private equity in the euro zone is concerned, there has been some gradual integration among the individual member countries themselves, but to a much larger extent between such economies and the UK. At the same time, the UK as a major financial hub has become substantially more integrated with the rest of the world, notably the US. One indicator is the ten-fold increase in inflows in UK funds from non-European investors between 1999 and 2006. Compare this with the commitments made by non-European investors to funds managed by GPs in the euro area, which rose by a relatively meager 67 percent during this period.

Thus, it seems that non-European investors who seek greater exposure to the non-UK European private equity market do so by committing capital to funds raised and managed in the UK. This process is being facilitated by the rising number of non-European fund managers which invest private equity funds out of their London offices (e.g. Accel Partners Europe, KKR Europe, TPG).(2) These funds are raised from European as well as non-European investors and compete head-on with funds raised by managers of European origin. In 2006, five of the top ten buyout firms in Europe were of US origin. These GPs participated in deals representing more than 30 percent of entire market volume.

Conversely, European GPs have found it much more difficult to penetrate foreign markets. In 2006, there was not a single European GP among the top ten buyout firms in the US in terms of overall market volume. Although some European private equity fund managers have redoubled their efforts to expand abroad, especially in the US but increasingly also in Asia, they are not yet in a position to provide European LPs with sufficient exposure to non-European markets. While the share of European funds deployed abroad has stagnated at around 5 percent of total fund commit-

FIGURE 5

Private Equity Investments in Domestic Companies by Domestic and Other European Funds, 2006 (€m)



Source: EVCA

ments, European LPs seeking exposure to non-European markets have substantially increased their commitments to foreign funds operating in the target market.

3. CONCENTRATION IN FINANCIAL INTERMEDIATION

As the European private equity market has grown rapidly and become more integrated, its industry structure has changed significantly. A small and distinct group of large European buyout funds is emerging, whose resources and skills allow them to operate on a pan-European basis. These funds, which are usually headquartered in the UK and sometimes maintain an office network throughout the main European markets, target relatively large deals where they compete with global funds of US origin. As discussed above, these large pan-European funds are the driving force behind the increased integration of the European private equity market. According to data reported by Thomson Venture Economics, large pan-European buyouts funds of (the equivalent of) more than $5 billion accounted for more than 60 percent of Europe's total fundraising market in 2006.

At the other end of the spectrum are small funds with a size (of the equivalent) of $500 million or less, which account for around 10 percent of the European buyout market. These funds show a strong home bias, with their investor base being largely domestic LPs and investments generally confined to small deals in the domestic market. Their competitive advantage is special knowledge in particular niches in domestic markets.

With large pan-European funds driving the integration process, the degree of market concentration has increased significantly in recent years. In 2006, the top 10 percent of European funds (in terms of size) accounted for around 55 percent of all capital raised in Europe, compared with just 45 percent in 1995.

Outlook

Looking forward, what can investors in European private equity expect? We see four broad trends.

First, the integration process is far from complete and looks set to gather momentum as other European financial markets, such as corporate bond markets and public equity markets, also continue to become more integrated. That said, complete integration is unlikely to be achieved as long as key investment parameters vary widely across individual economies in Europe. For example, a recent study by Apax Partners ranks 33 countries according to the attractiveness of the business environment for private equity. On a global scale, the UK comes second with an overall score of 4.8. France is ranked 15th with a score of 1.4, while Italy is 25th with a negative score of 2.5.(3) While individual country positions are of course debatable, it is clear that country-specific differences matter. Several factors are structural and therefore tend to be persistent - such as the restrictiveness of labor laws, the tax treatment of private equity funds and investment and corporate governance regimes.

Second, the elimination of currency risk and the convergence of individual business cycles in the euro area thanks to a common monetary policy favour sector-based investment strategies at the expense of country-based strategies in diversifying investment portfolios. Importantly, as far as public equity investors are concerned, there has been a marked decrease in their home bias since the introduction of the euro.

Third, geographical proximity is an important determinant of cross-border trade and financial flows. Over the next few years, Central and Eastern European economies will continue to converge towards the business cycle in the core EU countries. At the same time, as financial markets in these countries become more integrated with the European core, the factors making private equity in Central and Eastern Europe a different asset class look set to fade.

Finally, the industry structure of European private equity will continue to see significant changes. The experience in the US suggests market concentration is likely to rise further over the next few years. This process will be fuelled by continuing financial integration and deepening in other areas, notably debt capital markets. European buyout firms targeting larger companies on a pan-European level will especially benefit from this, enhancing their competitiveness vis-à-vis foreign firms entering the European market.

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Footnotes

1. Members of the euro zone include Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Slovenia and Spain. In addition to the 13 countries that form the euro area there are 14 countries, which are members of the European Union (Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, Sweden, and the United Kingdom). Furthermore, a number of European countries have decided not to join the European Union, notably, Iceland, Norway, and Switzerland.

2 Note that in the EVCA data base non-European GPs with offices and fundraising activities in Europe are considered as European institutions.

3 See Apax Partners, Private Equity in the Public Eye. 2007 Global Private Equity Environment Rankings. http://www.apax.com/EN/.