



**ACCESS CAPITAL PARTNERS**

Private Assets in Europe

## 2014 GENERAL PARTNERS MEETING SUMMARY



### Market views expressed by General Partners

On November 28<sup>th</sup> 2014, Access Capital Partners (Access) held its 14<sup>th</sup> Annual General Partners Meeting and gathered 79 of its small to mid-market buy-out and special situations General Partners (GPs) and 15 of its private debt fund managers to exchange views on the current state of the market.

Discussions covered the state of the investment and exit markets, financing conditions, as well as strategies implemented to outperform across economic cycles.

Participants were unanimous that robust exit activity was the dominant characteristic of 2014. Fund managers accelerated divestments and increasingly optimised portfolio liquidity through dividend recapitalizations. Yet new investment activity remained subdued as GPs faced a diverse deal flow (in terms of quality), and closing deals was hindered by differences in pricing expectations between sellers and buyers. Debt availability improved substantially during the year with the return of the banks and the supply of private debt providers. Finally, operational performance of portfolio companies also improved with the return of healthier sales and Ebitda growth.

## 1. Investment activity remains behind expectations

Despite the optimism that prevailed at the beginning of 2014, the environment remained challenging for GPs deploying capital. High levels of dry powder pushed entry prices upward while the weak economic environment and increased regulatory burden stretched the time required to close transactions. Direct sourcing capability was a key success factor for GPs to avoid over-inflated auctions.

### a. Deal flow: Volumes are volatile and quality is diverse

This year, GP Meeting participants reported being faced with a diverse deal flow in terms of quality. Consequently, identifying attractive opportunities was facilitated by proprietary sourcing, and required a high level of selectivity, as well as a rigorous investment process.

*"The market is very volatile: during one quarter, the deal flow presents some very attractive features and sound investment opportunities, and the next quarter it is very disappointing both in terms of volumes and quality."*

On the primary buy-out front, some participants drew attention to the fact that the scarcity of attractive opportunities can be explained by the unwillingness of many family owners (typically representing around 50% of completed deals in Access' funds) to sell their stakes in companies. It appears that families' main reservations lie in how to redeploy sale proceeds, given the low returns on traditional investments, uncertainties on the state of the capital markets in 2015 and fiscal instability in some European countries.

*"Whilst families are reluctant to sell companies, secondary buy-outs continue to fuel the deal flow in Europe."*

### b. Difference in pricing expectations between sellers and buyers reduced further the investment pace

It was generally agreed that the difference in pricing expectations was causing an additional drag on the investment pace.

*"The valuation gap between sellers and buyers is responsible for a higher mortality rate of potential deals. For more than half of the deals we analysed in 2014, the sale process was cancelled."*

The "mid-market" was said to be "expensive". Indeed, acquisition valuations for small and mid-market buy-out transactions combined increased further over 2014. The average EV/EBITDA multiple stood at 8.2x, significantly above its long term historical average of 7.3x.<sup>1</sup>

*"Meeting the pricing expectations and maintaining the same performance targets is challenging."*

High levels of dry powder, improving debt markets and competition from new players (notably family offices and "sponsorless" mezzanine funds) explain this evolution.

Fortunately, given its focus on "smaller" buy-out funds, Access' portfolios avoided most of this inflation, with an average entry multiple for deals completed in 2014 standing at 6.7x<sup>2</sup> across its funds of funds.

### c. Closing transactions takes more time

Yet another challenge GPs had to face in 2014 is that time required to complete deals is stretching as closing processes are becoming more tedious.

*"Investment activity is indeed slower and combined with an extension of the time required to execute deals."*

A number of factors explain the extension of time required to complete transactions. First, the outlook for 2015 remains uncertain owing to the lack of visibility on the economic recovery of the Euro zone. Then, the unstable geopolitical environment, especially the Ukrainian crisis and unrest in the Middle East

<sup>1</sup> Standard & Poor's

<sup>2</sup> Access Capital Partners, statistics on primary buy-out deals across ACF III MMBO, ACF IV GBO, ACF V GBO, ACF VI GBO, as of December 2014 (excluding turnaround deals)

put an additional strain on economic activity, leading some players to adopt a risk averse and cautious behaviour. Lastly, the increasing regulatory hurdles and subsequent compliance risks stretched the due diligence process for banks, mezzanine and private debt providers as well as equity buyers.

d. Creativity is a key success factor in order to close deals with strong value creation potential

With unrelenting pricing and competitive conditions, creativity and the ability to source proprietary investment opportunities are considered key competitive advantages. In the wake of reduced investment activity, fund managers have been increasingly looking at public to private transactions, corporate carve-outs, minority stakes in growth companies and complex situations in order to seize value creation opportunities.

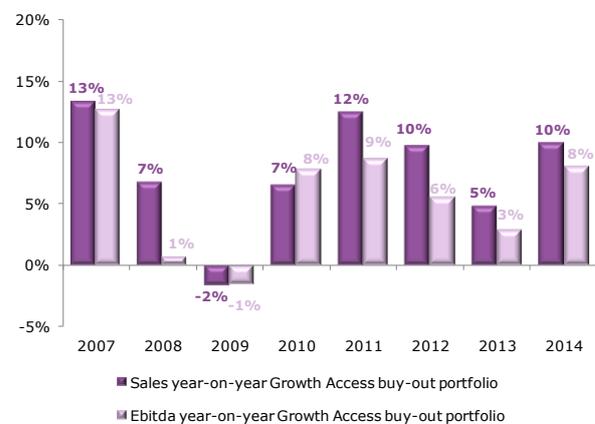
*"Creativity is required to source and close deals with strong upside. You can create value out of complexity."*

## 2. However, trading performances of portfolio companies improved during 2014

Typical value creation by smaller buy-out fund managers relies on genuine operational growth (increase in sales through organic growth, international expansion or acquisition, increase in EBITDA, operational optimization).

Understanding that relying strongly on deleveraging in order to achieve returns is generally not a viable strategy, small and mid-market buy-out fund managers continue to aim at "working the assets" even harder and intensifying operational support to their portfolio companies in an endeavour to compensate for the difficult economic climate.

Figure 1: Operational growth of portfolio companies



Source: Access Capital Partners / Statistics on Access' co-mingled small and mid-market buy-out Funds of funds. 2014 figures are projections based on budgets published by GPs as of Sept. 2014, actual figures can differ from these projections

2014 saw the return of healthier sales and Ebitda growth in the Access portfolio.

## 3. Value creation continues to rely substantially on buy-and-build and internationalisation

a. Buy-and-build: the benefits of concentration in fragmented markets

As organic growth is to some extent hindered by the lack of momentum of the European economy, business consolidation in fragmented markets (buy-and-build) continues to be favored by many of Access' GPs. The acquisition of add-on companies allows platform investments to benefit from economies of scales and synergies, thereby generating growth and facilitating higher valuations.

*"In a low growth environment, successful buy-and-build strategies allow the company to shift to a higher valuation multiple range."*

Over the past fifteen years, fund managers selected by Access have proven their ability to successfully conduct buy-and-build strategies, capitalizing on their in-depth industry specific knowledge, extensive network and experience.

Further, acquiring add-ons outside of Europe is seen as an efficient tool to internationalize portfolio companies.

- b. Non EU countries are driving growth for portfolio companies: capturing growth through internationalisation

Looking at portfolio developments in the prevailing environment, fund managers encourage internationalisation to foster growth as participants generally agreed that Non-European economies are mostly driving organic growth for portfolio companies. Technology oriented companies, as well as consumer goods, and services businesses tend to focus on the US market whereas manufacturing businesses target the Asian and South American emerging economies.

Access' GPs reported being increasingly inclined to open offices outside of Europe to support the expansion of companies, especially when considering local add-ons. They are also keen on establishing partnerships and relationships with local experts and facilitating knowledge sharing between management teams.

**4. Exits and portfolio liquidity improved substantially in 2014**

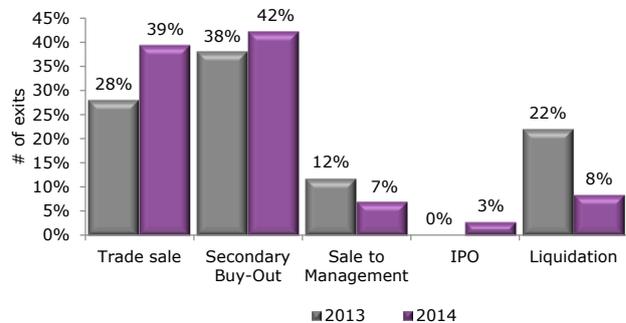
- a. Overall, the market environment in 2014 was characterised by favourable exit conditions for small and mid-market buy-outs

In the midst of a buoyant debt market, and on the back of increasing dry powder for corporate and financial buyers, Access' GPs benefited from a favourable exit window over the past year. 47% of GPs reported actual return multiples beating their expectations while divestment volumes were sustained at high levels.

Across Access' primary and secondary portfolios, 67 companies were realised at an

average gross cost multiple of 2.4x, up from the 55 exits recorded in 2013 (+22%).<sup>3</sup>

Figure 2: Different exit routes



Source: Access Capital Partners / Statistics on Access' co-mingled small and mid-market buy-out Funds of funds

Overall, the improved trading performance and a return in confidence stimulated exit activity in 2014. Trade buyers showed significant interest in acquiring Private Equity backed companies. Access' GPs reported that 39% of last year exits were to trade buyers (up from 28% in 2013) while secondary buy-outs represented 42% of all exits (up from 38%).

In line with the trend observed on the investment front, high levels of dry powder and investment periods coming to an end resulted in a significant number of Private Equity buyers being under pressure to deploy capital. This growing appetite for investment, accompanied by increasing availability of debt, continues to fuel exits via secondary buy-outs.

After weathering the storm that followed the 2008 financial turmoil, most pre-Lehman vintage portfolios, which were significantly marked down over the previous years, are now being realized and show capital appreciation.

- b. Liquidity is also arising from increasing amounts of dividend recapitalizations

GPs again emphasized the paramount importance of exit timing and liquidity management. Dividend recapitalizations have

<sup>3</sup> Source : Access Capital Partners – January 2015 – Statistics on exited primary buy-outs, growth and buy & build deals across ACF I MMBO, ACF II MMBO, ACF III MMBO, ACF IV GBO and ACF V GBO. The statistics do not include portfolio companies from fund positions that were sold on the secondary market



therefore become increasingly popular, on the back of favourable debt markets. While retaining the ownership of their portfolio companies, recaps enable fund managers to return cash to their LPs and keep an upside potential.

Given the current market conditions, many GPs reported being faced with a trade-off between selling companies now while the exit window is open or stretching the holding period in order to achieve greater returns through further improvements or add-on acquisitions. Many argued that they used recaps, with a moderate approach to leverage, to mitigate the impact of extending holding periods on the IRR and reach a higher valuation multiple range.

*"Deals closed in 2011 and 2012 present relatively low leverage levels due to the scarcity of debt available on the market at that time. After two years in portfolio, provided that the company is a good quality asset, re-leveraging as part of a dividend recap satisfies a capital efficiency rationale."*

In a market characterized by readily available debt at attractive conditions, recaps have become a tantalizing alternative. Fortunately, GPs have not forgotten the last pre-Lehman recap and its bitter sweet aftertaste as performing businesses incurred major disruptions as a consequence of excessive re-leveraging. Well aware of the potential risks implied, there is a consensus among Access' GPs that recaps are to be used with cautious and discernment.

*"We need to be cold hearted when deciding the amount we want to recap despite the fact that banks can be excited at the prospect of financing recaps."*

Access' GPs emphasized the importance of maintaining sufficient headroom to allow the company to grow and finance add-on acquisitions when required.

*"With appropriate discipline, recaps can actually improve the operational performance of a company as they allow adapting the debt structure to the needs of the business and*

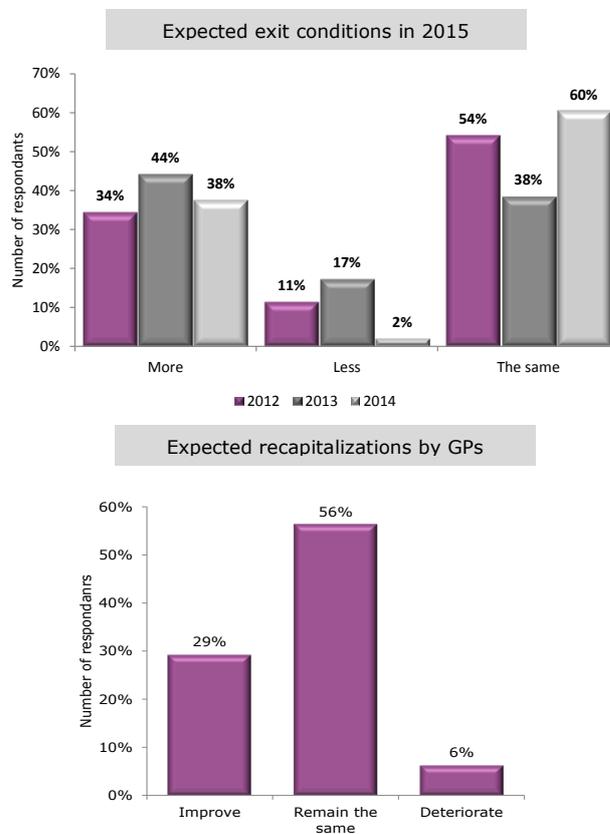
*most importantly give the opportunity to re-incentivize the management."*

Under such assumptions, portfolio companies' management teams are increasingly welcoming recaps as they are less disruptive to business operations than a straightforward exit.

From a debt provider standpoint, the picture seems to vary according to geographies: banks in the Nordic region exhibit a bullish approach and a strong willingness to finance dividend recaps. In the UK, GPs noted that banks are being less inclined to support recaps, while alternative debt providers seem to demonstrate strong appetite, offering bullish dividend recaps as evidenced by the testimony of turnaround fund managers.

Given the dynamics at work, fund managers believe that the outlook for 2015 will remain positive regarding portfolio liquidity.

Figure 3: Perception of exit outlook for 2015 by General Partners



## 5. Availability of acquisition debt financing increased substantially

### a. Increasingly diverse and rather bullish debt providers

Access' GPs have reported an increasing number and variety of debt providers offering financing options. However, the participants concurred that maintaining strict discipline when structuring deals is crucial and borne out by the facts: the average net debt/Ebitda multiple across Access' GPS stands at 2.0x for deals completed in 2014, below the historic average of 3.0x and below 2013 levels of 2.4x.<sup>4</sup> Conversely, leverage levels increased in 2014 for all European small and mid-market transactions with an average multiple of 4.5x (versus 4.4x last year).<sup>5</sup>

For many participants, especially fund managers operating in the Nordic region, alternative debt providers issuing bonds have been particularly popular in the past year as bonds can offer additional flexibility versus senior debt. However, on the downside, this type of financing implies a substantial level of uncertainty regarding the evolution of the high yield markets and the identity of the bond holders, which can hamper an efficient renegotiation of bond terms.

Some GPs indicated favouring unitranche as an alternative to senior debt as it is a debt instrument well suited for expansion plans, can simplify the debt structure and accelerate the acquisition process.

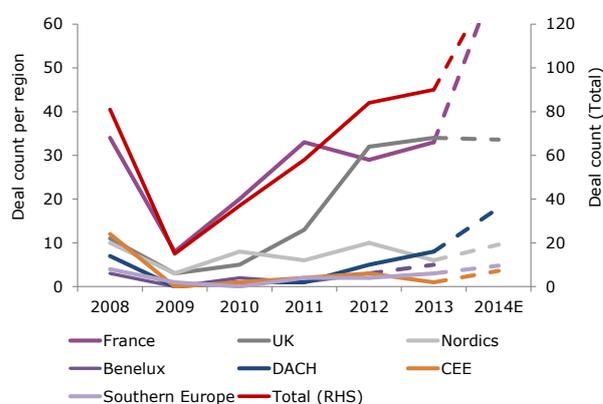
*"Unitranche providers have the ability to follow the pace on difficult deals and to react swiftly."*

### b. A new Paradigm emerged for mezzanine and private debt providers

Private debt and mezzanine providers on the small and mid-market buy-out segments were particularly resilient in 2014. Amid increasing levels of senior debt and moderate buy-out

investment activity, subordinated debt issuers witnessed a sustained level of activity. Despite a soft start, private debt providers' activity over the last twelve month exceeded 2013 levels and reached its busiest year since Lehman Brothers' collapse: 31% of Access' private debt fund managers reported a level of activity above historical average, while for 62% of them, it was in line with historical average.

Figure 4: Evolution of deal count per year and geography



Source: Access Capital Partners–Private debt deals (sub-debt and unitranche) in the small and mid-market

In terms of geography, France witnessed a strong level of deal activity in 2014 amongst private debt providers while the UK was lagging behind. Activity is picking up in other geographies, notably in German speaking countries and the Nordics.

The dynamism of the small and mid-cap mezzanine and private debt market arises from the ability of fund managers to consistently adapt their model to market evolutions. These fund managers remain pressured to continue their efforts in adapting and renewing their offering to match the requirements and objectives of investors, while meeting those of borrowers and equity sponsors. The incentive to maintain a high level of flexibility is also correlated to the increasing level of competition observed on that segment.

*"Plain-vanilla mezzanine deals will become even scarcer in the future. We have already*

<sup>4</sup> Access Capital Partners, statistics on primary buy-out deals across ACF I MMBO, ACF II MMBO, ACF III MMBO, ACF IV GBO, ACF V GBO, ACF VI GBO, excluding turnaround deals

<sup>5</sup> Standard & Poor's



*started with a progressive reshuffling of our strategies by integrating unitranche offers, direct equity exposure, or sponsorless deals.”*

- c. The increasing availability of debt: a threat or an opportunity?

The growing availability of debt and liquidity is nonetheless raising concerns regarding a potential overheating of the market.

In the light of this uncertain outlook, it is preferable for buy-out fund managers to work with established debt providers and push for vendor loans, rather than having recourse to aggressive and opportunistic new entrants. Going forward, GPs backed by Access continue to advocate a responsible and conservative use of debt and leverage.

Buy-out fund managers remain disciplined, clinical and well aware of the potential risks. They continue to focus on high quality assets with strong operational potential for buy-out transactions.

## 6. Conclusion

The general sentiment that characterized Access' fund managers this year was cautious optimism.

Macroeconomic uncertainty continues in Europe, with low visibility on future growth prospects. Closing deals was challenging in 2014 and investment activity was below expectations, mainly due to the widening gap between buyer and seller valuation expectations. The increase in availability of debt raised concerns regarding a potential overheating of the market.

Notwithstanding the foregoing, very positive developments were observed over the last year on the exit front and strong operational growth was seen amongst portfolio companies which returned of healthier sales and EBITDA growth.

In conclusion, Access continues to believe in the resilience of the smaller buy-out segment to deliver long term sustainable returns across the cycles. Narrowing down manager selection

to GPs with direct sourcing capacity, implementing active growth strategies in Europe and worldwide as well as maintaining a strict pricing and leverage discipline will continue to be key success factors going forward.



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