Europe: Finding the Sweet Spots for U.S. Investors

Europe has traditionally been seen by U.S. private equity investors as a market rich in opportunities. While it remains true that the European private equity market is less mature than in the U.S., the market is becoming increasingly competitive. Operating as a U.S. private equity investor in Europe is complex, requiring an understanding of multiple national markets. Notwithstanding the fact that interesting opportunities for U.S. investors do exist, it is still too early to tell whether the initial U.S. entrants have been successful. This article will address the top questions that U.S. investors contemplating a European investment are posing.

Is there lots of low-hanging fruit for private equity investors in Europe?

No, the European private equity market is at least as competitive as the U.S., with more deals conducted by investment bank auction and fewer proprietary deals.

The last few years have seen a surge in European LBO activity. In 2001, the value of deals done in Europe outstripped the U.S. market for the first time. However, despite growing opportunities in Europe, the private equity market has become highly competitive.

On the one hand, the flow of funds into private equity has risen dramatically as institutional investors continue to increase allocations to private equity. One result of this is that the market has seen major European players, such as Apax, Candover, Doughty Hanson, Cinven and CVC Capital Partners, raising billions of dollars for Europe-focused funds.

Added to this has been the growth in auctions as a means of conducting acquisitions. Auctions are particularly prevalent in the UK market. But they are increasingly being used to increase the efficiency of the acquisition process elsewhere. Across Europe, virtually all large deals are now conducted by auction.

This has made it harder for private equity funds to find proprietary deal flow. The auction process, often conducted by the large U.S.-based investment banks, has made it very difficult to find deals below fair market price, and has pushed prices up and expected returns down. As a result, the focus of private equity funds has shifted strongly toward how to add value to their transactions rather than merely relying on financial engineering to generate returns.

Europe is one market these days, right?

Wrong. Europe is still a multitude of different country markets each providing differing opportunities and requiring local knowledge and networks.

Europe is not really one market for private equity, despite the launch of the single currency and growing harmonization of legislation. Opportunities differ considerably by country, with the private equity market at varying stages of maturity across Europe.

The UK market has traditionally been the most advanced, and accounted for 50% of all European deals by value 1997-2001. However, recent growth has been stronger in Germany, Italy and Sweden, and much of the current effort of European private equity investors has shifted toward such markets.

European governments and the European commission have realized the great potential economic benefits of private equity. As a result, structural reforms are in progress in the major markets and at the EU level, for example Germany's removal of capital gains tax on the sale of shareholdings and recent corporate law reforms in Italy. (See "German Tax Reform: A Primer for Fund Managers," *The Debevoise & Plimpton Private Equity Report*, Summer 2001 and "Italian Corporate Law Reform Promises Friendlier Deal Environment" elsewhere in this issue.) These reforms will prove beneficial in the medium term by increasing deal flow and flow of capital into the asset class, but in the short-term significant differences exist in legislation between countries which will continue to mean that market dynamics differ between states.

Furthermore, the competitive situation and key success factors required within each market create different levels of opportunity for private equity investors. For example, the Italian market is much less penetrated by private equity than comparable countries, but is very difficult for foreign funds to operate in part due to the importance of strong domestic political and business contacts. Scandinavia, on the other hand, has opened up rapidly to external private equity investors, with external investors' share of deals by value rising from 28% in 1997 to 61% in 2001.

The key to operating in Europe is to understand that private equity is predominantly a local business. Some of the larger deals can be conducted on a pan-European basis from one location. But for mid-market deals it is critical to have a local presence, a local network, local advisors who understand national and European industry structures and trends and a familiarity with language, customs and culture – this takes time to build.

So where's the angle?

Opportunities exist in Europe to create value by restructuring acquisitions. However, this can be difficult to achieve given government regulation, employment legislation and union strength in some countries, and the pool of European turnaround management is small.

Compared to the U.S., European labor laws generally afford a far greater degree of employee protection. This can be problematic for private equity funds hoping to create value from restructuring their investments.

Legislation differs across Europe. One example of legislation making restructuring very difficult exists in France. There, layoffs must follow a strict procedure, which takes not less than 180 days before they can finally be implemented. If changes are made to the proposed retrenchments during the period, the 180-day period restarts.

Another problem facing private equity investors in Europe is scarcity of managerial talent available to execute turnarounds. First, the talent pool is small overall, and, second, for any given deal there exist national, language and geographic barriers to accessing that talent. Some U.S. investors have resorted to bringing in U.S. management, but there have been high-profile cases where this has failed to work due to a clash of management styles and culture.

When the talent is available, incentivizing that talent appropriately can be tricky. UK managers typically respond to U.S.-style incentives, like stock options. But continental managers do not always. For example, in Germany, management tends to put a higher priority on community standing and cooperation at the work place than on financial incentives. Furthermore, some U.S. private equity investors have provoked a strong negative reaction in the business community in some countries by announcing U.S.-style management compensation packages that are viewed as excessive compared to local norms.

Despite the difficulties, there are some examples of U.S. private equity investors taking a value-added approach and successfully improving performance of their acquisitions in Europe. For example, Texas Pacific Group is in the process of driving growth and increasing EBITDA ahead of the industry at its UK pub chain, Punch Taverns.

What's the opportunity for taking public companies private?

Taking public companies private is a rapidly growing source of deals, with the advantage initially of allowing "quasi-proprietary" deal flow for private equity funds.

Historically, public to private deals in Europe have been rare given complex legislative requirements and corporate control rules. But transactions of this type are growing. European stock market sentiment has moved away from smaller stocks, and this has led to a growing perception among private equity investors that many smaller stocks are undervalued. This has fueled public-to-private transactions, which rose from less than 4% of European deals by value in 1997 to 20% by 2001.

Public-to-private deals can allow a private equity investor to understand the company better and potentially develop an advantageous relationship with an incumbent management team before they bid, after which management is required by law to disclose the bid and thereby open up the acquisition to other players.

Are there any interesting exit opportunities?

The secondary market (sales of companies from one private equity investor to another) is providing a greater opportunity for exit.

The secondary market provides a growing source of potential exit for European private equity investors. From 1997-2001 approximately 8% of European private equity deals were secondary market sales, and this is likely to increase as long as IPO market conditions remain difficult.

Are there many privatization opportunities left?

Interesting state privatization opportunities still exist; however, networks and political connections are key.

Following hectic activity in the late 1990s, the rate of privatization in Europe is slowing, with $47 billion raised from privatizations in the EU in 2000 vs. $60 billion in 1999. This drop can be attributed partly to a reduction in the number of assets left to be privatized, but also to unfavorable equity markets that have caused states to postpone privatization plans.

However, attractive opportunities do still exist, particularly in Eastern Europe and in sectors where liberalization is incomplete, such as telecoms and energy. And there is evidence that private equity investors will play a bigger part in privatizations going forward, with governments increasingly seeing private equity as an alternative to the IPO.

One of Europe's high-profile private equity investors, Guy Hands, former head of Nomura's Principal Finance Group, has recently set up his own firm, Terra Firma Capital Partners. Terra's goal is to invest about 40% of its new fund in German government privatization projects.

The major U.S. private equity players have already been successful in Europe, haven't they?

It is too early to tell whether any of the major U.S. players have been successful in the European market, as there have been few exits. Those that have not yet entered are behind the game, particularly given barriers to entry.

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Sponsored Spin-offs (continued)

is required to file with the SEC on a Form 10 and provide to the shareholders an information statement, which contains essentially the same disclosure as required for a registration statement on Form S-1 under the 33 Act. The fourth factor – the need for a valid business purpose – also addresses the issue of whether the parent company receives value for the spun-off shares. Examples of a valid business purpose are allowing management of each business to focus solely on that business, providing employees of each business stock-based incentives linked solely to his or her employer or business' performance, enhancing access to financing by allowing the financial community to focus separately on each business and enabling the companies to do business with each other's competitors.

For the Division, the fifth factor ensures that Parent will not be deemed an underwriter engaged in a public distribution of "restricted securities." The two-year holding period does not apply where Parent formed the subsidiary being spun off.

Staff Bulletin No. 4 also confirms that the Division will not require 33 Act registration simply because the parent company asks its shareholders to vote on the proposed spin-off. So long as there is a valid business purpose for the spin-off, the Division declared that a vote on the asset transfer that may be involved in the spin-off does not change the overall nature of the transaction.

Form 10 is used to register the spun-off securities under the 34 Act. Much like an S-1 prospectus, the information statement included in the Form 10 describes the spun-off company's business, properties and management, and includes information on executive compensation, employee benefit plans, financial data, management's discussion and analysis of results of operations and financial condition and historical and *pro forma* financial statements. SEC review of a Form 10 registration statement is substantially similar to that for an S-1.

Structuring the sale of a non-core business as a spin-off clearly involves significant and challenging hurdles and will require close coordination with counsel and other advisors; yet it can often be the only good way for a corporate parent and a prospective private equity investor to tap the pent up value in an underutilized line of business.

— Paul S. Bird and Peter F.G. Schuur

Guest Column (continued)

Many of the major U.S. players such as Clayton, Dubilier & Rice, Inc.; Texas Pacific Group; Kohlberg Kravis Roberts & Co.; Providence Equity Partners and The Carlyle Group have entered the European market. In most cases, initial offices have been set up in the UK. Some are beginning to venture further onto the continent.

Their presence is reflected in the share of European deal value taken by U.S. investors, which has risen from 4% in 1997 to 13% in 2001, with a further 7% share in 2001 accounted for by syndicates which included U.S. players. U.S. private equity investors have been successful with some European investments made from their U.S. operations, such as Texas Pacific Group's acquisition of Ducati and Bain Capital's investment in SEAT. However, many U.S. players have found entering Europe on their own and expanding across the continent challenging. Several, such as Blackstone and Bain Capital, have been in Europe for several years but have yet to do many deals from their European operations.

There have been some high-profile successes though, such as KKR's acquisition and subsequent IPO of financial services firm Willis Corroon. But other than that, there have been very few exits to date by U.S. investors, and so it is too early to judge success.

Is it too late to get in the game?

U.S. private equity investors that have not yet entered the European market will find themselves behind when they do, particularly give barriers to entry such as the need to build local networks in European markets. U.S. players currently in Europe are trying to build these networks, for example by recruiting senior advisors such as former UK Prime Minister John Major at Carlyle, or senior industry figures as investment professionals. A thorough understanding of opportunities within each market and European industry trends and structures and the strategic issues facing particular acquisition targets will be critical to success.

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