

THE 2005 DROEGE-CHAZEN PRIVATE EQUITY FORUM
European Opportunities: From Fund Raising to Deal Making
April 13, 2005

Written by Helena Plater-Zyberk, Chazen Society Fellow

While the United Kingdom continues to generate and consume the lion's share of European private equity activity, opportunities abound across the continent. At the Droege-Chazen forum, top minds leading nine key American and European-based private equity firms assembled to exchange views on market trends, swap behind-the-curtain tales from their own headline-grabbing deals, and offer strategic insight to those seeking to share in the region's potential for high returns.

Opening remarks from Professor Charles Calomiris, Academic Director of the Chazen Institute, Columbia Business School, and Markus Lahrkam, President, and Dr. Walter Bickel, Senior Partner, Droege and Comp., touched upon the institutional differences between the European and American marketplace and set the stage for the energizing discussions to follow.

The first panel, moderated by Eric Estes, Partner, Campbell Lutyens & Co., stressed the importance of local knowledge when operating in foreign markets and highlighted the recent spate of buyout opportunities across the continent. Panelists included:

- *Natalie von Niederhausern, Senior Vice President, Swiss Re*
- *Andreas Mach, Managing Director, HypoVereinsbank*
- *James Kestner, Managing Director, Allianz Private Equity Partners*

Keynote speaker, Professor Matthew Rhodes-Kropf of Columbia Business School, outlined the challenges PE firms face in meeting and exceeding returns expectations.

The second panel, moderated by Thomas J. Maloney, President, Lincolnshire Management, explored opportunities not just in Europe but across the globe and reiterated the importance of local partners. Panelists included:

- *Jonathan Colby, Managing Director, The Carlyle Group*
- *Mark T. Gallogly, Senior Managing Director, The Blackstone Group*
- *Philippe M. Costeletos, Managing Director, The Texas Pacific Group*
- *Alan Peyrat, Principal, Apax Partners*

Summary of Discussions:

Despite the unfamiliar legal structures, in particular jurisdictional variations in taxation and contract law, diverse market fundamentals, and the sometimes meager choice of exit options, crisscrossing the Atlantic in search of the next big deal is becoming ever more popular.

The playing field. Europe's venture capital sector has never been as strong as in America. As a result, the large firms are very much interested in buyout opportunities over other options. While the overall European PE market saw a drop-off in the post dot.com era and has not yet returned to

2000 levels, the share of transactions dedicated to buyouts has been increasing steadily since 2001. Driven by large companies' consolidation efforts and subsequent offloading of non-core businesses, 78 percent of European PE activity was focused on buyouts in 2004. Mezzanine level activity holds onto a small space and will possibly grow slowly.

"Europe today feels like the US in the 80s," says Phillippe Costeletos, The Texas Pacific Group. "There is a tremendous amount of restructuring opportunity."

"A lot of businesses both mid-sized and large are simply not well run and can be improved," agrees Jonathan Colby, The Carlyle Group. "A lot of businesses will be sold."

Speakers highlighted some of Europe's hotbeds of activity. The Nordic region and Southern Europe (Italy and Spain in particular) are predicted to surpass traditional markets such as Germany or France in terms of investment activity and more specifically fundraising. This bodes well for growth in the entire European PE landscape, when one considers that net investments in Germany grew by 56 percent from 2003 to 2004. A recent study cited Luxembourg, Ireland, Greece, the Netherlands, Portugal, and Belgium among other top European fundraising sources and investment destinations.

European investors are characterized as more cash-flow driven than their American counterparts who often focus on underlying value. Many see fund managers becoming more pro-active and agree that diligence quality has been improving. Overall, it is the European investors who are backing the European funds. Americans are encouraged to join this space.

Increasing deal size. The growing attractiveness of the once rare 'mega' club deals is a very hot topic these days. This trend is expected to continue as deal sizes grow and increasingly larger firms are acquired. "Large funds are now the ones driving the European PE market," says Eric Estes, Campbell Lutyens & Co.

A rising proportion of deals is equity financed. With investment limitations in place to ensure diversification of portfolios and without a reliance on the staggering leverage ratios of days of old, club deals are a popular way to ensure sufficient equity to enact the transaction. Current excess in funds is attributable to flight from capital markets.

Some see the 'mega' buyout trend as cyclical. "Corporate acquisitions have been vacant from the market, so PE is moving into that space," says James Kestner, Allianz Private Equity Partners. "What we've seen is corporates outbid by consortia, creating price issues, which is possibly a cause for concern."

Citing a recent success with Itay's Fiat, which was hesitant to allow the French a carve out, Mark Gallogly, Blackstone, sees opportunities for American firms in Europe in roles as the "lesser of two evils." American firms operating in Europe can sometimes position themselves as the default option, "like the Swiss."

Local knowledge key to success. While pan-European funds are growing in popularity, pan-European thinking is not. "Europe may be one economically and politically, but countries are very different," cautions Andreas Mach, HypoVereinsbank.

There was absolute consensus that the ins and outs of various countries' markets must be evaluated individually. "Diligence approach may be the same for US- and European-based funds, but consider different approaches, different strategies in different markets," advises Kestner.

In seeking local partners, one needs to examine track record, experience, past performance, and the quality and cohesion of the team. The most important consideration is management, says Natalie von Niederhausern, Swiss Re. "You want to know fund managers on a personal level."

Remember the risk. Not surprisingly, the unfavorable Euro-US dollar exchange rate is a notable concern for many American investors. Panelists remarked that it is a struggle to include the exchange fluctuations in the decision-making process. Some firms are considering a risk premium on US dollar-based investments. The weaker dollar, they also noted, does present opportunities to European based funds. Bifurcated funds may be one preferred means to avoid currency-related risk.

One major concern in the German market, as well as other European markets, is the dearth of exit options. Without an active capital market to support IPOs or a swarm of ready corporate buyers, profits may remain illusive.

Both Dr. Bickel, Droege & Comp., and Professor Rhodes-Kropf, Columbia Business School, highlighted the downward trend in overall internal rates of return (IRR).

An alternative for seekers of high IRR may be distressed private equity opportunities. These riskier opportunities generally produce up to 30 percent higher returns than their less risky alternatives.

With top firms' history of delivering returns that far exceed the market, it should come as no surprise that hedge funds may increasingly try to nip at private equity's heels. When questioned whether intersection is imminent between hedge fund and PE activity, panelists opinions varied.

Hedge funds are not "patient capital" in the way that PE is. But at least one panelist feels that "the game has not been played out yet." Heads nodded in acquiescence when Gallogly stated what has been on many minds. "They'll go where the returns are."

Global outlook. Growth requires global presence. In the future, expect to see more European PE firms coming to US, says Alan Peyrat, Apax. "Size matters. You must be large to be a global firm."

Firms are cautious in Russia and Central and Eastern Europe, however. Certain Russian sectors, such as aerospace and energy will be monitored. In the rest of the region though, the opportunities remain small. Currently, there is little reason to set up dedicated country offices and reluctance involved in creating a pan-Eastern European fund.

Not surprisingly, the current of the conversation eventually turned toward China and India. Given the amount of attention they receive from market watchers, participants wondered whether any of the major PE players were poised to take part in the action. Across the board, panelists stated that interest was there, but that time would be needed to establish a solid local presence before engaging in any specific deals. Consensus was that firms are not yet comfortable investing there without people established on the ground. Thus the advice issued for Asia rings true globally: do proceed, but with eyes wide open.

The big players have these words of advice for smaller firms looking to source and invest in new markets: do go to Europe early, do your due diligence, question market views, look for new angles, and local partners can make all the difference in navigating unfamiliar territory.