Why Europe?
Why Now?

by Miriam Schmitter, PhD; Enrique Millán
& Margaux Fessard de Foucault

The Case for Private Equity Investments in Europe's Lower Mid-Market

Private Equity (PE) has long been a driver of growth and strong returns, and in today's economic climate, we believe that Europe's lower mid-market offers a compelling opportunity. A still somewhat fragmented European economy allows buyers to benefit from sometimes inefficient markets and hard to access opportunities. Buyers can find lower entry multiples, high-growth sectors, experienced and highly motivated management teams and ample scope for value creation through internationalization.

In this post, we will explore the key factors making Europe's lower mid-market a prime target for PE investment at this point in time.

A LARGE MARKET WELL SUITED TO PE INVESTMENT

Europe's economy is large and diverse, with the economy of Europe[1] combined GDP standing at approximately $23.1 trillion in 2023, making it the second-largest economy in the world, after the U.S. ($27.4 trillion) and above China ($17.9 trillion). However, what sets Europe apart is its reliance on SMEs. According to the European Commission, 99% of all businesses in the EU are SMEs, accounting for over 50% of the region's GDP.[2] 1.4 million represent small businesses with 10 employees or more and can be considered investable target for PE funds.

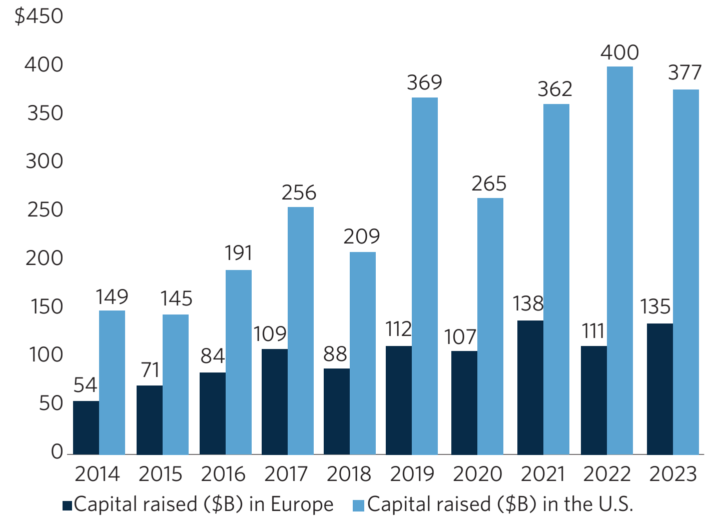
These SMEs are often family-owned and undercapitalized, making them ideal targets for PE investments. Many of these companies are in need of professionalization, digital transformation, or expansion into new markets, offering numerous opportunities for PE firms to add and generate value.

A LESS COMPETITIVE INVESTMENT ENVIRONMENT

Compared to the U.S., the European PE market remains relatively uncompetitive. In 2023, European PE firms raised €122 billion, marking a strong year for fundraising despite global economic uncertainty. However, 54 % of this capital raised was attributed to five large-cap firms,[3] with only €11.5 billion raised for the lower middle market (funds <€500 million).[4] While ten years ago, around twice the amount of capital was raised for the U.S. PE market compared to Europe, over the last few years this has been closer to three or even four times, indicating a much higher level of competitiveness.

HISTORICAL FUNDRAISING IN EUROPE AND THE U.S.

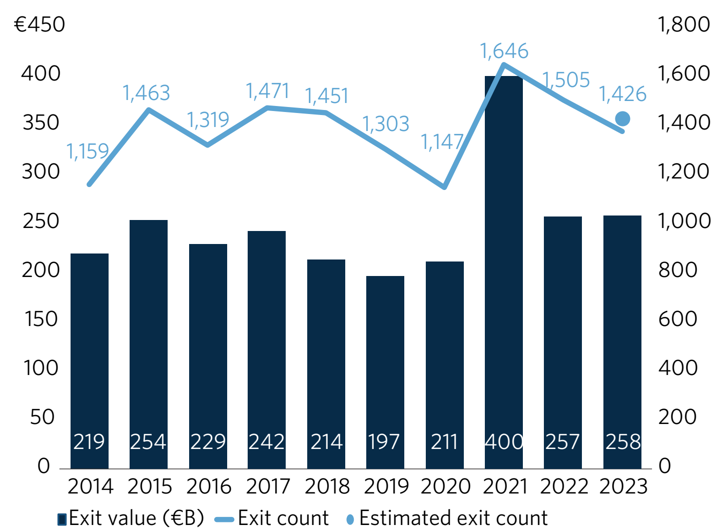
Dollars in billions as of June 30, 2024



Source: PitchBook. (2024). "European PE Breakdown. Q2 2024;" PitchBook. (2024). "U.S. PE Breakdown. Q2 2024."

EUROPE PE EXIT ACTIVITY

Euros in billions as of June 30, 2024



Source: PitchBook. (2024). "European PE Breakdown. Q2 2024."

Exit activity has remained resilient, with 2023 exit volumes above the long-term average, although down from the exceptional levels of 2021 and 2022.

1 EU, United Kingdom, Switzerland and Norway. Tradingeconomics.com as for 2023.
2 European Investment Fund. (2023). "Annual Report on European SMEs."
3 These five large-cap firms are CVC Capital Partners' Fund IX, Permira's Fund VIII, KKR's European Fund VI, PAI Partners Fund VIII, and Bain Capital European Fund VI.

As indicated by the lower amount of capital raised, we believe that the European PE market is less competitive in particular compared to the U.S. This is also evidenced in the lower entry multiples being paid: In Europe, the median EBITDA purchase multiple in 2023 for leveraged buyout transactions was 10.2x (which are levels that have not been seen in Europe since the 2013-16 period) and that compare favorably to the 13.3x in the U.S.[4,5] providing attractive entry valuations for investors.

Additionally, the number of GPs (general partners) in Europe has expanded, with both established firms and spin-offs entering the market, leading to increased specialization and expertise.

SUPPORTIVE BANKING ENVIRONMENT

The European banking environment tends to offer more favorable loan terms and structured financing for the PE industry, with lower interest rates often offered by local lenders and less reliance on public debt markets compared to the U.S. Additionally, European banks maintain closer, relationship-based lending practices, which can be helpful when supporting a less straight forward lending case.

WHY NOW?

1. High-Growth Sub-Sectors

Despite sometimes lacklustre overall GDP growth across Europe, we see many themes and sectors benefiting from significant tailwinds, driving growth at significantly faster rates.

- Digitization / tech-enabled services: Strong regulatory support, a skilled talent pool, and an emphasis on digital transformation across industries in Europe have allowed this sector to grow significantly.

- Consolidation of fragmented service industries: This ongoing trend is reshaping sectors like healthcare, logistics, and professional services in Europe. Buy-and-build focused GPs have strong expertise in identifying targets, managing integration, and crystallizing synergies, while avoiding the pitfalls inherent in consolidation processes.

- Healthcare: Similar to other developed regions, Europe's aging population is driving increased demand for healthcare services, alongside innovation in life sciences and biotech, making these sectors ripe for PE investment.

2. Less Competition

Compared to the U.S., Europe's PE market is less saturated, particularly in the lower mid-market. This implies less competition for deals, which leads to more favorable entry multiples and less inflated valuations. While the average EBITDA purchase multiple in 2023 for leveraged buyout transactions was 10.2x in Europe, it was 13.3x in the U.S.[4,5]

3. Expertise and Barriers to Entry

Europe's fragmented markets, combined with diverse country-specific regulations, can be challenging to navigate due to differences in legal frameworks, languages, and cultures across countries. While these complexities can act as barriers to entry for some, they also represent significant opportunities for those with the necessary local expertise to navigate them effectively. PE firms that are familiar with the regulatory landscape and have local networks are in a strong position to capitalize on these fragmented markets, making local expertise a key competitive advantage for successful investments in Europe.

4. Resilience in Addressing Challenges

Europe has demonstrated its ability to handle economic shocks and adapt to changing circumstances. The recent energy crisis, triggered by the war in Ukraine, tested Europe's resilience given the continent's dependance on Russian natural gas. Europe has made a quick and decisive shift away from reliance on Russian natural gas, accelerating its transition to renewable energy sources and with energy prices normalizing to pre-war levels within one year. This ability to pivot and respond to crises is a key indicator of the stability and long-term viability of investments in Europe.

4 PitchBook. (2024). "European PE Breakdown. Q2 2024."
5 PitchBook. (2024). "US PE Breakdown. Q2 2024."

5. PE Talent Growth and the Rise of Spin-Outs

As Europe's PE market matures, the talent pool has been expanding with a growing number of spin-outs from larger PE firms. These emerging teams, characterized by their youth and ambition, are often highly specialized in specific sectors or regions, giving them a competitive edge over larger, more generalist firms. Additionally, their smaller size and absence of a legacy portfolio allow them to be more dynamic and agile in adapting to new market trends. To assess these new groups, experience in the market and strong networks are required from LPs (limited partners).

6. Exit Opportunities: U.S. PE Firms Keen on Buying European Assets

In addition to the traditional exit routes to strategic buyers, IPOs or secondary buyouts by other European sponsors, we have seen an increasing interest from U.S. PE firms for European targets, either as single platforms or as add-ons for their existing portfolio companies. In recent years, cross-border M&A activity has surged, with U.S. firms paying premiums for well-established European companies. Cross-border North American acquirers accounted for 26.7% of all M&A value in Europe in 2023.[6] This creates an additional lucrative exit environment.

CONCLUSION

The combination of Europe's large SME universe, high-growth sub-sectors, lower entry multiples, and a generally less competitive market positions the region an attractive destination for PE investment. With a growing talent pool, the ability to navigate challenges, and a resilient exit environment, Europe's lower mid-market offers a compelling value proposition for PE investors.

For those seeking to diversify their portfolios and capture value in a less saturated market, Europe's lower mid-market presents an attractive opportunity for sustainable growth and significant returns.

6 PitchBook. (2024). "Global M&A Report. Q2 2024."

This page intentionally left blank

Important Notes

Certain information contained herein has been obtained from or is based on third-party sources and, although believed to be reliable, has not been independently verified. Such information is as of the date indicated, if indicated, may not be complete, is subject to change and has not necessarily been updated. No representation or warranty, express or implied, is or will be given by The Common Fund for Nonprofit Organizations, any of its affiliates or any of its or their affiliates, trustees, directors, officers, employees or advisers (collectively referred to herein as "Commonfund") or any other person as to the accuracy or completeness of the information in any third-party materials. Accordingly, Commonfund shall not be liable for any direct, indirect or consequential loss or damage suffered by any person as a result of relying on any statement in, or omission from, such third-party materials, and any such liability is expressly disclaimed.

All rights to the trademarks, copyrights, logos and other intellectual property listed herein belong to their respective owners and the use of such logos hereof does not imply an affiliation with, or endorsement by, the owners of such trademarks, copyrights, logos and other intellectual property.

To the extent views presented forecast market activity, they may be based on many factors in addition to those explicitly stated herein. Forecasts of experts inevitably differ. Views attributed to third-parties are presented to demonstrate the existence of points of view, not as a basis for recommendations or as investment advice. Market and investment views of third-parties presented herein do not necessarily reflect the views of Commonfund, any manager retained by Commonfund to manage any investments for Commonfund (each, a "Manager") or any fund managed by any Commonfund entity (each, a "Fund"). Accordingly, the views presented herein may not be relied upon as an indication of trading intent on behalf of Commonfund, any Manager or any Fund.

Statements concerning Commonfund's views of possible future outcomes in any investment asset class or market, or of possible future economic developments, are not intended, and should not be construed, as forecasts or predictions of the future investment performance of any Fund. Such statements are also not intended as recommendations by any Commonfund entity or any Commonfund employee to the recipient of the presentation. It is Commonfund's policy that investment recommendations to its clients must be based on the investment objectives and risk tolerances of each individual client. All market outlook and similar statements are based upon information reasonably available as of the date of this presentation (unless an earlier date is stated with regard to particular information), and reasonably believed to be accurate by Commonfund. Commonfund disclaims any responsibility to provide the recipient of this presentation with updated or corrected information or statements. Past performance is not indicative of future results. For more information, please refer to Important Disclosures.

Published October 2024

A Commonfund Company

Darien, CT 06820
New York, NY 10017
San Francisco, CA 94111
London, United Kingdom
Beijing, China

Tel (203) 563-5490
Tel (646) 348-9201
Tel (415) 433-8800
Tel +44 (0) 20 8126 1628
Tel +86 10 8509 8706

15 Old Danbury Road
Wilton, CT 06897

Tel 888-TCF-Main
Tel (203) 563-5000