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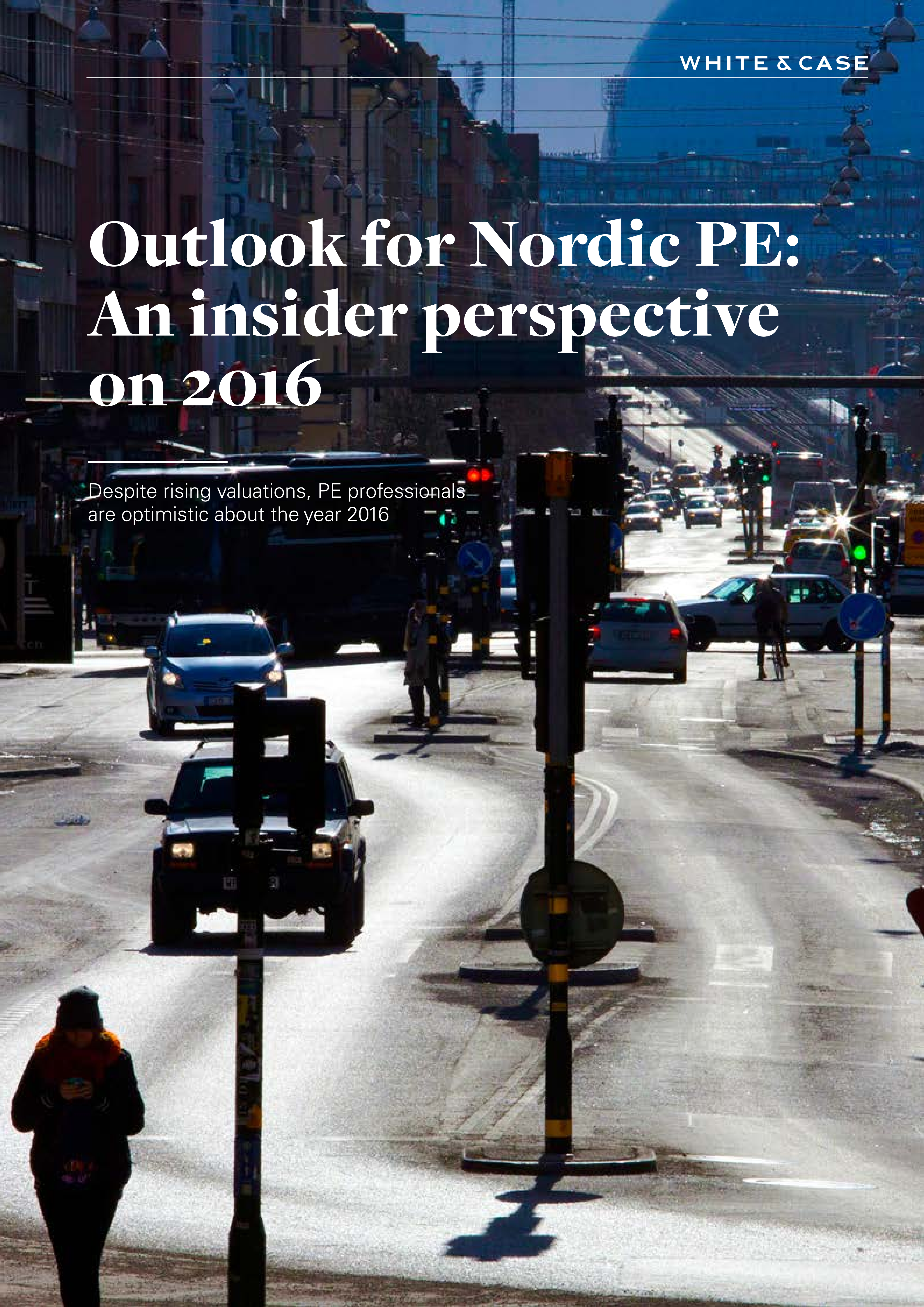
Outlook for Nordic PE: An insider perspective on 2016

Despite rising valuations, PE professionals are optimistic about the year 2016



Outlook for Nordic PE: An insider perspective on 2016

Private equity professionals identify strategies that firms are pursuing to drive growth even as competition remains fierce

By Ulf Johansson, Lennart Pettersson and Henrik Wireklint

In 2016, private equity (PE) in the Nordic region is likely to meet or exceed 2015 performance, according to investment professionals we interviewed early this year. But insiders also say that firms are adjusting their business models to account for new realities, such as the persistence of high valuations that have significantly raised the hurdle for profitability of portfolio companies

In the first two months of this year, we conducted extensive interviews with 15 investment professionals from leading Stockholm PE firms to get their perspectives on the Nordic market. All were optimistic about 2016, but the professionals also highlighted a number of challenging trends stemming from increasing competition for good deals.

Chief among these was the need for firms to focus on operational excellence and build industry expertise to ensure they maximize the value of their portfolio companies. Virtually every firm sees this as critical at a time when high valuations continue to threaten return on investment (ROI).

Many are also adopting new criteria for identifying targets with greater ROI potential. That may involve specializing in more complex deals that other buyers lack the skills to handle, or focusing more on market or regional niches that are not on competitors' radar.

Most investment professionals said that firms will continue with co-investments, which enable them to pursue deals that they might not otherwise be able to finance. And firms are increasingly likely to purchase M&A insurance to hedge their risks in this high-stakes environment.

But despite some challenges, investment professionals didn't waver in their belief that Nordic PE will see a continuation of the positive performance that has been characteristic of the region in recent years.

A new watchword: "operational excellence"

Asked about their top business priorities for 2016, nearly all interviewees cited the need to build up their capacity for bringing "operational excellence" to portfolio companies.

The traditional PE progression of identifying attractive assets, buying them at a favourable multiple, ensuring a robust management team and then making a well-timed exit is no longer enough, these experts say.

Firms are increasingly recruiting industry experts to ensure that the management teams of portfolio companies get enhanced support from PE funds to fuel industrial value creation. For example, Stockholm-based EQT AB has recruited Henrik Landgren, former VP of Analytics at Spotify, and Andreas Thorstensson, co-founder of Toborrow, both of whom will add tech expertise to EQT's venture fund table. Jersey-based Nordic Capital has recruited Olof Faxander, former CEO of Sandvik and SSAB, two of Sweden's flagship industrial companies, as operating partner and co-head of its Operations team.

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Interviewees say having such figures on the team reassures portfolio companies that the PE fund is serious about creating real industry value—which is all the more critical when assets are purchased at high multiples. Diversifying the background and bolstering the expertise of the PE funds' own advisory teams in this way helps deflect the persistent criticism that PE funds lack sufficient industry expertise to be successful active owners. Demonstrating these internal competencies to potential fund investors may aid fundraising, as well.

And this approach can help persuade industrial sellers who may be reluctant to sell to PE funds, according to interviewees. Family and partner-owned businesses in particular are easier to win over when sellers have confidence that the target company will continue to be run by someone who understands them and their business.

High multiples spark a search for ROI

All of the investment professionals we interviewed said they expected their firms to do at least as many deals in 2016 as in 2015, and several expected to do more. But continued high multiples are affecting how these firms choose their targets.

One executive said his firm plans to seek out more complex and challenging transactions in the hope of avoiding competition and securing more attractive multiples. Others plan to target regional markets or business sectors where current valuations remain more attractive than in other regions or sectors.

For example, US healthcare companies may offer lower, more attractive multiples than do Nordic and other European healthcare companies, and Swedish software companies may make more attractive targets when located outside of the Stockholm area where multiples may be inflated, interviewees say.

Because 2015 was such a robust year for Nordic IPOs, the mid-size and large-cap M&A sector has shrunk, and investors are watching to see if the volatility in Nordic stock exchanges at the start of the year will lead to an increase in M&A exits in 2016.

Most interviewees expect the IPO window to remain open in 2016, but they also expect the number of IPOs to go down. Some noted that the especially high volatility in exchanges at the time of the interview had made them think twice before initiating a new IPO, and that trade sales may be preferable for many 2016 exits. A few interviewees predicted that the IPO window may close for a long time due to erratic market behavior.

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Market volatility may give rise to more specialist funds and a sharper industry focus in the small PE fund segment, where every fund is looking for a sweet spot away from the high multiples of secondary exits.

Although PE funds will still be looking to participate in auction processes initiated by their competitors, the interviewees say they are becoming somewhat more skittish where auctions are in play, as auctions can drive up prices past the point where achieving sufficient ROI remains likely.

Co-investments are here to stay

Nearly all interviewees said taking on co-investors will continue to be common practice, at least among mid-size and large PE funds. Most such funds have commitments to certain investors to offer co-investment opportunities and have gradually streamlined the process of onboarding co-investors into new deals.

While co-investment can reduce management fees for PE firms, they can also increase the amount of funding that PE firms are able to raise. This can enable them to compete for deals that might otherwise be out of reach. Some interviewees said that they like co-investments because they can help the PE firm to assemble valuable business competence for closing the deal and for raising value post-closing.

Co-investments that involve a group of many small, passive investors are often more attractive than those that involve only one or a few active minority investors, the interviewees say.

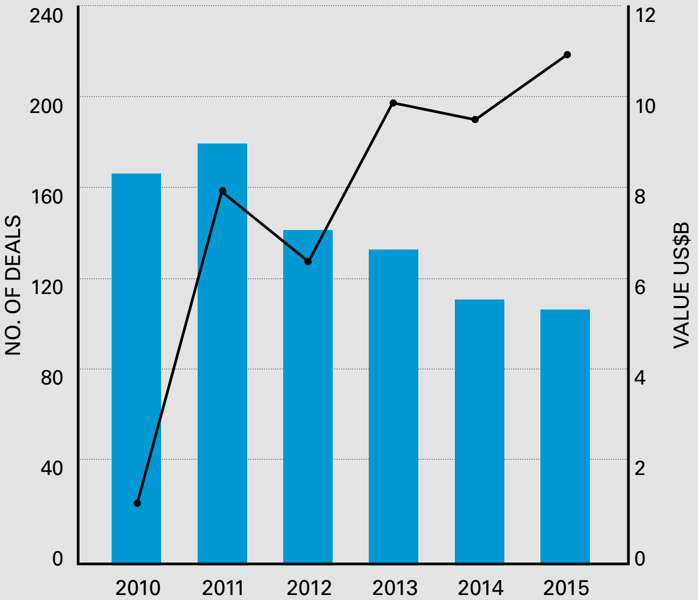
Investors are attracted to co-investment options because they usually give investors more control. In particular, co-investors typically play a significant role in selecting the targets that the PE firm invests in over the life of the fund.

Co-investments do add to the administrative burden for PE firms, increasing the resources they have to expend to accommodate investor requests for information and manage how they interact with the fund. Co-investments also add to the complexity of executing deals, requiring internal deal teams and external deal counsel to manage co-investment details in parallel with transaction workstreams. But investment professionals say the increased burden is manageable, and that the results often justify the extra effort.

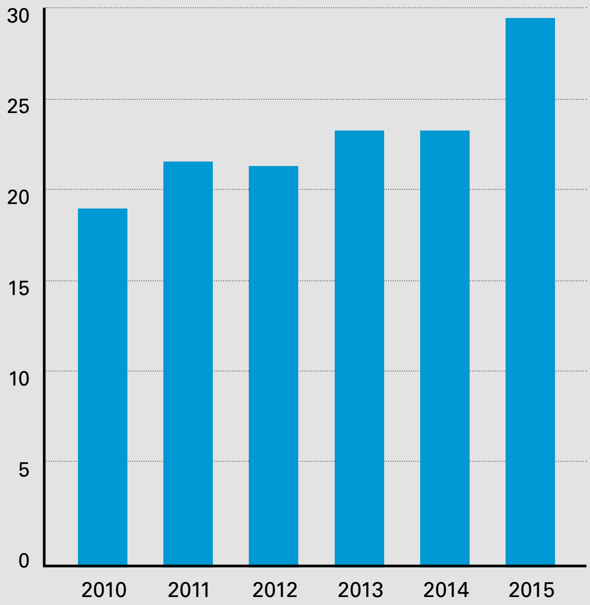
Interviewees say that they may sometimes wait to enter into co-investments until after signing a deal, but that they do so only after careful consideration of the increased risk. Those that wait could fail to find co-investors and may have to shoulder the full investment

Nordic PE: Ins and outs

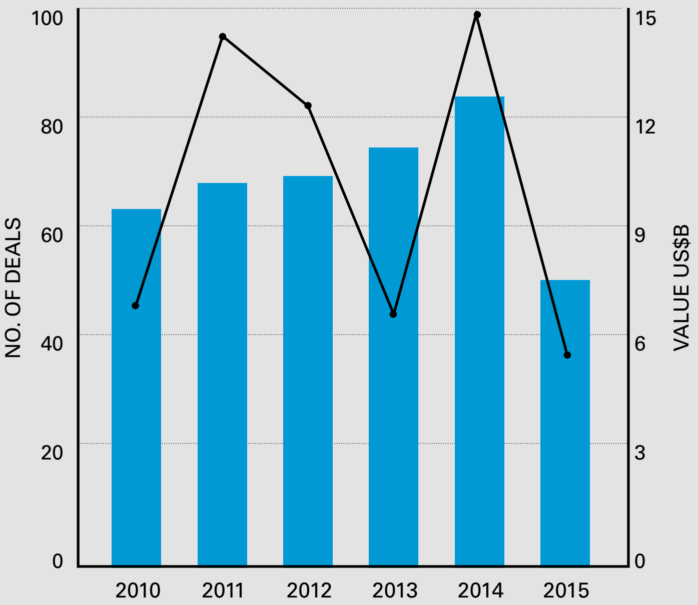
Buyouts
2010 – 2015



Capital reserves
2010 – 2015 (US $ billion)



Nordic exits
2010 – 2015 (includes IPOs, secondary sales, trade sales)



Number of deals
Value of deals

Note: Nordic countries include Sweden, Norway, Denmark, Iceland and Finland
Source: Thompson One Banker; Preqin

themselves. This could put them in breach of investment terms they have with existing investors in their fund. Of course, the risk is eliminated in cases when the share purchase agreement for a deal contains a condition precedent, such as an equity financing-out, that enables the firm to walk away from the deal if it can't obtain sufficient co-investment.

M&A insurance gains popularity

Use of M&A insurance will continue to rise, according to interviewees, particularly for seller-initiated auction processes. Nearly all interviewees said that they consider M&A insurance for every investment and exit case they evaluate.

But when deal terms are considered attractive, Nordic PE firms may still see the cost of M&A insurance as too high for an exit relative to the risk and decline to buy it.

The scope and premiums for tax and environmental warranties could also dissuade firms from buying insurance. Depending on the operational footprint of the target company, protections for environmental and tax warranties may be very expensive while still not offering exhaustive coverage.

And where a fund is hoping to pre-empt an auction process, the aggressive pace at which such transactions play out can prevent a fund from acquiring insurance, given the time insurers may demand for checking the buyer's due diligence and the time the buyer may need to make corrections the insurer wants. Such transactions may proceed without insurance, unless the seller has already obtained insurance to cover the deal.

Wild cards: Politics and the media

Most interviewees agreed that long-term clarity on the tax situation in the Nordic region is a top priority. Some blame the tax uncertainty for the decision by several offshore funds to postpone plans to bring funds onshore, and representatives of onshore funds said adverse tax rulings could make them consider moving to offshore structures.

Most interviewees were also concerned about continued negative coverage of PE firms in the media, which they believe is responsible for poor public perceptions of the sector. Some PE firms have made changes to how they do business in reaction to media coverage.

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For example, although they may continue to invest in welfare-related targets, some PE funds may be less likely to take on such investments in the short term in order to steer clear of any media-generated controversy that might have the potential to damage the deal's success for all parties.

To combat PE's PR problem, many firms have made efforts to increase transparency, and some have ramped up their public relations activity (in the past, firms tended not to respond to media criticism). More PE funds are also launching corporate social responsibility programs, in part to improve their public image.

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Dynamics have changed for Nordic PE in recent years, but leading firms are adapting in ways that will enable them to continue to grow. Most agree that the sector's positive performance will continue at least through 2016. ■

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