BDO KNOWS INTERNATIONAL PRIVATE EQUITY: SPOTLIGHT ON THE U.K.

Lee Duran, and **Scott Hendon**, BDO USA's Private Equity practice leaders, sat down with **John Gilligan**, M&A Partner of BDO United Kingdom, to discuss the latest PE trends in the U.K. Here are some insights from their conversation.

Lee Duran

Scott Hendon

John Gilligan

What is the investment environment for private equity funds in the U.K.?

The investment environment in the U.K. is finally starting to settle following the market downturn of 2007. The banks here were hit especially hard because the U.K. tends to rely on retail banks, and at the time we didn't have debt funds. But since then, debt funds have arrived from the United States, which has led to a big change in the banking market over the past eight years or so. We're seeing far more unitranche providers in the debt market and less reliance on the banks that have traditionally been the backbone of our economy – RBS, Lloyds, Barclays, HSBC, etc. During the transition from retail banking to direct lending through debt funds, there were very few transactions, but now that pace is picking up again.

Another factor impacting the investment environment is a change in banking regulations that has made lending a more difficult process for banks over the past five years. The cost of capital for loans has increased for the banks, forcing them to reduce the terms of their loans – making private investors a more attractive option than banks for companies seeking debt financing. Essentially, we're finally beginning to see the results of the adjustments the market made in response to the 2007 financial slump. The environment is stabilizing, and there are a significant number of active debt funds in the U.K. and in Europe. There is a sense of exuberance in the air.

What investment trends are you seeing?

We're definitely seeing an increasingly crowded mid-market, as players from above and below push into the space. The bigger funds in this market tend to be firms that have historically pushed themselves up–market, but are now settling back in the middle and are beginning to find their niche. In that same vein, the whole industry has started to move toward a sector-focused strategy. At the top end, industry players are leveraging sector expertise as their go-to-market strategy. That's very different from the industry's historical approach over the past 30 years, when most funds positioned themselves as generalists.

Another interesting trend to note is that partners are more actively involved in the management of their companies than they have been in the past. The "operating partner" concept hasn't been adopted here as it has in the United States, but the model is beginning to migrate here. It's important to note that what you see in the States tends to happen in the U.K. four to five years later, depending on the cycle – from the structures we're using with debt to the operating partner model to sector specialization.

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What type of capital flow are you seeing coming into the U.K.?

We find ourselves a landing point for many U.S. companies looking to break into the European market. In Q1 of this year, about 25 percent of deals in the U.K. were led by U.S. sponsors. This can be attributed in part to the cultural closeness, language and legal similarities between our countries.

What fundraising trends are you observing?

Fundraising is less of a concern than it was two years ago. At the time, there was a bifurcation of the market: Funds that had been successful and consistent, with low volatility in their returns, were able to raise the capital they wanted. But those with patchier records had a far more difficult time. Most of those funds have been able to work through the challenges, though, and eventually succeeded in raising the funds they sought.

What do holding periods look like, and what exit trends are you observing?

We're seeing a lot of refinancing, more than we have seen historically. Funds are also extending their holding periods; an LP recently told me that the average life of a 10-year investment in PE is now 14 years. The average life of an individual investment is now seven or eight years, whereas historically it would have been closer to four or five. Everything is taking longer, which means returns are decreasing as cash flows lag.

The overhang of cash is starting to wear out as well, with the funds raised in the mid-2000s having all exited. In the tail end of the last couple of years, there was a sense of urgency in the industry – those who had raised funds and needed to deploy them were vigorously scouring the market for exit opportunities. That period is now waning. Those who have weathered the storm have their new funds and, to a degree, the market is normalizing. But private equity takes a while to normalize because the structure is deliberately longer-term.

Platform investing is also ingrained in market activity. Everyone is thinking of investments in terms of turnarounds, secondary buyouts or platform investing – a strategic differentiator from past decades. The search for primary deals is the holy grail of private equity.

Are there any industries that are particularly attractive to foreign investors?

The U.K. had gone through a period of de-industrialization, but is now re-industrializing – probably because our exchange rate allows us to do so. As a result, over the past three to five years, manufacturing has done particularly well – a notable turnaround.

The U.K. continues to remain a primarily services-based economy – it's what we're good at! Financial services in particular has experienced monumental disruption and, since disruption favors PE, that sector has been particularly active. In the leisure and travel sector, we are noticing that people across the country seem to be eating out more. There is a lot of casual dining that wasn't around 25 years ago, and our work is reflecting that.

What do you think will be the next hot opportunity for PE investment in the U.K.?

There are two areas that will be interesting to watch. The first is the emergence of global mid-markets. That's never been there before, and it's coming. The idea of local PE markets might be dissolving.

The other trend we're keeping an eye on is the globalization of law firms. Technology is changing the way legal processing works, and PE is investing in the back end. One can see a world in which the legal profession undergoes a similar change to that seen in the accounting profession, where there is movement toward a "global standard." Lawyers are having this conversation more frequently than they have in the past. It will be interesting to see what other opportunities emerge for PE investors as the conversation continues to evolve.

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