Survival of the Smallest?

An Update on the European Lower Middle-Market Private Equity Segment

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EXECUTIVE SUMMARY

Private Advisors manages funds-of-funds focused on lower middle-market private equity strategies. In an effort to shed light on the current investment opportunities and challenges in this market segment, in Europe, we recently surveyed a group of general partners (GPs) with whom we regularly interact. The key findings are listed below:

I. Availability and Cost of Debt

A. Debt for leveraged transactions is available to the tune of €50-75 million, at leverage multiples between two and three times EBITDA[1].

B. While in almost every European country one or several banks have withdrawn from lending to buyouts, in most cases two to five banks remain active.

C. Unlike the current environment in North America, the cost of financing European lower middle-market buyout transactions has not changed significantly compared to pre-credit crunch levels. Specifically, increased deal fees and credit spreads have been offset by decreased base rates.

II. Portfolio Company Performance

A. As expected, recent company performance in the European lower middle-market is mixed, with idiosyncratic positives and negatives within an overall downward trend for revenues and profits.

B. More resilient sectors have been healthcare, consumer staples, utilities and critical business services. Weaker ones include consumer discretionary, mechanical engineering, automotive, transportation, building materials and media.

III. Portfolio Company Valuations

A. European lower middle-market valuation multiples are in the process of adjusting, with valuation ranges down by one to four EBITDA turns.

IV. Equity IRR Underwriting Targets

A. European lower middle-market GPs' IRR expectations are unchanged at 25-30%.

V. Deal Flow – Buyers and Sellers

A. Private equity and to a lesser degree strategic buyers are actively seeking European lower middle-market acquisitions, but they are price sensitive.

B. Corporations refocusing on core activities, distressed industrial and financial firms, and family-owned businesses facing succession issues or a need for growth capital are active sellers of companies in today's market.

VI. Current Market Observations

A. We are not seeing important changes to GP business models. Succession and growth driven opportunities continue to support traditional business building focused small company buyout strategies.

[1] Earnings before interest, tax, depreciation and amortization

Background

Private Advisors has focused on lower middle-market private equity investing since the firm's inception in 1997, and our partners have invested with and advised investors and companies in this market segment for the past two to three decades. We have consistently advocated the advantages of small company buyouts and we feel that while the overall private equity market clearly faces challenges today, the small end of the market still offers attractive investment opportunities. We believe the main reason for this is the ability of experienced GPs in this segment to increase the enterprise value of their portfolio companies through operational improvements. These measures include augmentation and professionalization of management teams, introduction of better financial control and accounting systems, improvement of marketing and sales functions, and expansion into new markets and products either organically or through acquisitions. While these types of value creation opportunities exist in other parts of the private equity market, we believe they are easier to identify and execute in smaller companies.

To prepare this paper we spoke to representatives of 33 European GPs managing funds ranging from €200 million to €1 billion in size. These conversations took place throughout the months of March, April and May 2009. The GPs we spoke to typically focus on transactions in the €25 to €200 million enterprise value range and are the kind of managers we are in daily contact with at Private Advisors. We believe that they are all highly qualified, experienced and well regarded investment teams. They are active in various geographical or industry-focused segments of the European market and typically they invest in companies in a specific country. In the interest of clarity, we will refer to the survey group as the "GP sample." Some of these GPs are named in the appendix to this paper, while others have opted to remain unnamed. We thank them all for their kind assistance in providing input for this document.

We queried the GP sample on the following main themes: current cost and availability of debt for leveraged transactions in the European lower middle-market; company valuations, fundamentals and deal flow; and current and future investment opportunities. We think the outcome is both interesting and reasonably encouraging. We also think that important conclusions can be drawn from it regarding the relative strength and resilience of the European lower middle-market private equity segment.

I. Availability and Cost of Debt

A popular notion, in both Europe and North America, is that little or no debt currently exists for leveraged buyout transactions. The consensus view is that loan syndication has evaporated and that banks, rattled by the credit crunch, have ceased to lend. Clearly the pace of transactions has slowed considerably, and some go as far as to say that the buyout model as we know it is dead for the time being.

Somewhat to our surprise, the GP sample responded nearly unanimously in their belief that debt is readily available for lower middle-market buyout transactions in Europe. But they also highlighted that there are clear limits to banks' willingness to lend, both in terms of absolute amounts as well as compared to a given company's financial strength and ability to pay back loans. Today, GPs in most European markets can get up to €20-25 million of long term loans from a given bank, and active banks are typically willing to leverage companies up to about two and a half to three times EBITDA. This compares to a virtually unlimited appetite for debt volume at aggressive eight, nine or ten times debt to EBITDA multiples available in the wider buyout market before the credit crunch.

Three things should be noted here. First, it is widely acknowledged that lower middle-market GPs, on average, never relied as heavily on leverage as those GPs focusing on middle-market and large buyout transactions. The typical pre-credit crunch debt to EBITDA multiple range in the European lower middle-market was four to five, while comparable European middle-market and large buyout multiples were in the nine to eleven range. We believe returns in the lower middle-market have tended to stem more from operational improvements, including enhanced management teams, rather than the use of leverage. We anticipate operational improvements will drive returns in the future as well. Second, current loan availability is predicated on GPs having a long track record, a team of experienced investment professionals, and an existing relationship with their lending banks, whereby these banks know the GP team's past investment history. Such a relationship is a very valuable asset today. This was not necessarily the case during the height of the credit boom. Third, debt availability has become much more deal-specific today, where only high quality businesses with strong market positions, clear competitive advantages, and relatively stable end markets, in terms of demand, are currently financeable. As one GP put it:

> *"The best way to describe the banks' current appetite for providing structured finance to new credits would be to quote a Swedish financier commenting on whether his bank is active, to which he responded; 'Absolutely, we're open for business – as long as it's a non-cyclical, risk free credit that provides a high return.' He wasn't joking."*

Subject to the aforementioned caveats, we believe transactions with enterprise values up to €100-150 million can still be financed. We derive this level based on two observations. First, based on feedback from the GP sample, the new European lower middle-market paradigm is a debt to equity ratio of about one (i.e. 50% equity and 50% debt). And second, with two to five banks active in most European markets there is effectively the ability to access debt of about €50-75 million for a desirable transaction, while still maintaining a manageable bank "club" (most GPs seem to think three banks is the most they can manage effectively).

Other interesting observations from the European lower middle-market, in terms of debt availability, include the following:

- In past syndications the relevant bank involved in a deal would lead the syndicate and place the debt with other holders. In contrast, today most debt placement roles are handled by private equity GPs who effectively put together their own bank club before exclusivity is obtained from the seller of a company.
- Cross-border lending has been significantly reduced. According to the GP sample, active banks today tend to be the "local suspects" primarily: HSBC, RBS, Lloyds and Clydesdale Bank in the UK; BNP, SocGen, Calyon and CIC in France; Deutsche Bank, WestLB, BHF and IndustriKredit in Germany; Unicredito, Intesa/SanPaolo, Mediabanca and Banca Populare in Italy; BBVA, Santander and Caixa de Madrid in Spain; ABN Amro and Rabobank in the Netherlands; Nordea, Handelsbanken, SEB and FIH in Scandinavia. Foreign banks have less of a presence today, in all markets, perhaps with the exception of French banks such as BNP and SocGen, which still seem to be active in a number of countries outside France. Most notable in their complete absence are the Icelandic banks, for obvious reasons, but many other banks have, at least for the present, withdrawn from the leveraged loan market.
- Financing creativity has increased, with the use of vendor notes, earn-outs and similar practices coming to the fore. These techniques are utilized not only as a source of financing, like in the early 1990's, but also as a means to bridge price expectation gaps between buyers and sellers of companies.
- Mezzanine within the capital structure is not as prevalent as one might expect in the current environment and generally does not seem to be perceived as a viable financing option across the GP sample. This is mainly due to its high cost and increased complexity within the capital structure. This appears different from North America, where mezzanine debt is enjoying a renaissance in the current market.

Another popular notion is that even where available, debt is so prohibitively expensive that leveraged transactions do not make economic sense (i.e. debt pricing has increased such that transactions cannot be justified from an equity return perspective). Again, the evidence from our lower middle-market GP sample does not support the popular perception. GPs did report that spreads charged by banks have increased significantly; typically from about 150-200 basis points above the base interest rate in the pre-credit crunch environment to about 350-400 basis points above it today. Interestingly, the GP sample was nearly unanimous in their price quotes, regardless of their geographic base. Another significant difference is the up-front fees charged by banks, which in most cases are up from about 150-200 basis points of the loan pre-credit crunch to somewhere between 300 and 500 basis points today. However, these increases are largely offset by an approximate 300 basis points decrease in the base interest rate of most European countries, from an early 2008 level of around 450 basis points to about 150 basis points today. Unlike the market in North America, the GP sample has not typically seen banks put floors on these base rates, thus the absolute level of the cost for these loans is largely unchanged. Upfront fees apart, and recognizing the previously mentioned "flight to quality" with regards to debt availability, annual financing costs are actually slightly lower. Consequently, we would draw the conclusion that not only are banks open for business in the European lower middle-market, but also the cost of debt, where available, remains essentially unchanged compared to pre-credit crunch levels.

In terms of covenants the lower middle-market never saw any widespread use of "covenant lite" type loan terms, and the GP sample for the most part has not seen the introduction of more arduous terms by banks. GPs also reported that "bullet", or "balloon" loans (i.e. low to no amortization with repayment concentrated at end of the term) are hard to obtain today; the banks are demanding amortization schedules that allow them to be paid back earlier. Another observation is that banks have a tendency to "rub salt in the wound", when they can, by using covenant breaches and waivers as an opportunity to re-price and increase the cost of debt.

II. Portfolio Company Performance

In terms of company performance in the current economic environment it is clear to us that there are bad cases in the lower middle-market, just as there are in the larger private equity segments, but for the most part companies owned by the GP sample seem to be weathering the downturn. Part of this is due to lower company leverage going into the downturn compared to some of the larger private equity-owned businesses, and part of it is because the companies are small and therefore nimble. As the cliché goes, it is easier to steer a tug boat clear of a storm than it is a supertanker. With regards to absolute financial performance, the responses from the GP sample are multi-faceted and vary from individual GP to GP, as well as from country to country. Some GPs have been hit harder than others, depending on the composition of their portfolio, and are surprised by the effect of the downturn on their holdings, whereas others are surprised to the upside and are seeing their underlying businesses cope well. Not surprisingly, adequate diversification and prescient investment judgement appear to be critical factors driving current portfolio performance.

In terms of broader trends, GPs reported that companies in cyclical industries such as consumer discretionary, mechanical engineering, automotive, logistics & distribution, building materials and media & advertising are suffering in the lower middle-market as they are elsewhere. The magnitude varies from company to company, but 10-30% lower revenues in 2008 compared to 2007 were typical, with isolated cases of worse performance. More stable industries such as healthcare and pharmaceuticals, consumer staples, energy, telecommunications and critical business services are faring better. In many cases private equity owned companies in these industry verticals are growing, both in terms of revenue and profit; however growth rates may be down and/or lower than projected.

Another notable observation from our conversations with the GP sample is that within the overall negative trend in terms of revenues and earnings, many small businesses are more subject to micro or niche factors compared to larger companies which appear to have a higher correlation of results to the overall economy. Positive examples include niche-oriented consumer businesses continuing to grow strongly despite the current environment, entrepreneurial outsourcing businesses increasing revenues and profits, as well as, less surprisingly, some individual healthcare and pharmaceutical companies performing well. By way of a concrete example, one of the GPs mentioned a UK focused quality fast food business in their portfolio. The company produces and sells traditional Cornish pies and so far is growing through the recession. Of course, it is difficult to generalize why some niche businesses buck the prevailing trend. However, in the case of this particular business it is a differentiated product representing a unique customer proposition, aggressively priced and offering good value for money. Negative examples include things as diverse as small businesses suffering from weather related problems, changes to local tax regimes, overexposure to a large local client in an economically exposed industry, and exposure to Russia or other troubled geographic markets.

As alluded to previously, small companies can more quickly and easily implement cost cutting and other measures aimed at dampening the impact of the downturn. Conversely, among the supertanker companies of this world many will keep heading for the eye of the storm with no ability to throw themselves into reverse. The feedback we are getting on this point is very clear; given the speed with which the downturn hit this time, the timing of cost cutting and other defensive measures has been absolutely critical and the companies that were early in implementing such measures are much more likely to survive and prosper. Many of the GPs reported seeing portfolio companies running into margin difficulties in mid-2008, and that as such they started preparing the businesses for a different economic climate. On the other hand, companies that are only beginning to embrace cost-saving initiatives may be too late.

GPs also reported that company specific operational improvements, such as the build out of a management team or the moving of production to a low cost geography, have offset the impact of decreasing revenues. In another case, investment in a company’s sales structure has led to new clients coming onboard, offsetting revenue decline from existing ones. Accordingly, while GPs in this segment of the market may have challenges within their portfolios just as in other parts of the market, their ability to create or increase operational efficiency and react quickly to changes in the economic climate has been paramount to maintaining performance. When the economy does turn, these small private equity owned businesses are more likely to emerge “lean and mean” with the ability to take share in their respective markets at the expense of competitors facing financial and other difficulties.

With respect to geographic performance trends it is difficult to generalize in terms of countries and regions that have been hit harder than others by the downturn, but clearly those with a concentration in sensitive industries are suffering more than others. Germany is an example of a country where suppliers to the auto industry are struggling. Spanish companies with exposure to the building materials and construction sectors are another. Central European companies with un-hedged currency exposure are a third.

III. Portfolio Company Valuations

The feedback on valuations was more varied than that on company performance, especially when comparing countries. A general caveat is that conducting a market study in the current environment is a challenging task, as deal volume is low and consequently transactions to use as reference points are limited in number. As mentioned initially, the GP sample represents investors from most of the major European countries, including some located in Eastern Europe. In terms of the convergence of buyer and seller value expectations, the GPs responses varied by geography. They also varied significantly depending on industry and between companies that are weathering the downturn well and those that are not. It follows from this that price expectations also vary depending on the nature and predicament of the seller, a topic we will discuss further in section V below.

To give a few concrete examples of what we have heard on the valuation topic, and the wide ranging feedback we received, in the Nordic region responses ran from seller price expectations not having adjusted and the expectation gap still being large, to vendor expectations being pretty much re-aligned. However, the majority of GP feedback from the Nordic region suggests that pricing has come down from around eight times EBITDA previously, in most sectors, to the four to six times EBITDA range today. One GP is currently looking at a number of deals across IT services, consumer discretionary and healthcare, where they expect to pay as little as four times EBITDA on average – clearly a significant reduction from what they would have needed to pay for these businesses pre-credit crunch.

Several UK focused GPs told us that valuations in the lower middle-market are down one to two turns, from around eight times EBITDA to six times, and others that they are now looking at deals for five to eight times EBITDA. These are deals for which they would have had to pay seven to twelve times at the peak. Benelux GPs suggested that valuations have come down to four to eight times EBITDA, from six to ten times previously in that region. In the DACH region (Germany, Austria, Switzerland) GPs are seeing multiples move down toward the four to six times EBITDA range, but valuations are still situation dependent. One GP said that in a recent deal the seller was valuing the company at five and a half times 2008 EBITDA, whereas the GP was prepared to pay four and a half times 2009 EBITDA, a significant difference based on expected lower 2009 earnings, not to mention a deal breaker in this particular case.

In southern Europe significant price adjustment seems to have occurred, with valuations down from double digit multiples in most sectors, at the peak, to six to seven times EBITDA for quality companies now. We heard of companies in heavy industry sectors trading as low as two to four times EBITDA. Here again there were nuances, with one Spanish GP reporting overall valuations down only about one turn of EBITDA, albeit with the expectation of another turn down in the near future. This particular GP sees a big difference between cyclical and non-cyclical businesses and has the former category at six to nine times EBITDA and the latter at four to five times.

From Central Europe it was reported that pricing was highly inefficient at the time of our discussions for this paper, as most sellers were reluctant to sell at levels lower than they were being offered one or two years ago. Some adjustment had been seen already, although it had been slow and in stages, and people were clearly expecting more in the months to come. One GP said seller expectations were adjusting downwards, but that buyer expectations had adjusted downward even faster. Another put the gap between buyers and sellers at about two times EBITDA, saying that:

> *"We would estimate that asks are around six to eight times EBITDA, and bids at four to six times. Both are considerably lower than one year ago though."*

An advisor we spoke to in Hungary described the situation as:

> *"The Titanic has hit the iceberg, but the piano is still playing."*

So what do we make of all of this? For one, it is clear that the much debated seller expectation adjustment process is still under way, with valuations moving down. What was a situation of total stand-still only a few months ago, based partly on the inability of buyers and sellers to agree on price, is now showing signs of progress. Based on what we have heard, the predominant expectation is for valuations to continue downwards until company performance finds a floor and gains upward momentum at some indeterminate time in the future.

Indeed, according to the GP sample, one of the main reasons for the current slowdown in deal activity is lack of clarity around valuations, driven mainly by uncertainty around company earnings. Also, until recently company valuations were based on 2008 realized financials, whereas in the current environment buyers are trying to get more clarity about reasonable expectations for 2009. Some GPs express an expectation that deal volume will pick up in H2 2009, due to a combination of vendor capitulation and increased visibility in terms of 2009/2010 results.

IV. Equity IRR Underwriting Targets

One of the questions we asked the GP sample was about underwriting assumptions in terms of IRR, and to what extent expectations have changed in the current economic climate. On one hand, it could be argued that IRR expectations should be lower since less leverage is available for transactions. On the other hand, since it is widely acknowledged that risk has re-priced, one could expect that equity IRR hurdles have increased. In most cases the GP sample responded that IRR expectations are largely unchanged; most GPs are still underwriting transactions at 25-30% annualized IRR. The justification for this is partly that purchase prices are coming down, offsetting the impact of reduced leverage levels employed. GPs also appeared more confident in their ability to reach the "high cases" in their projections, primarily through strong execution (e.g. taking market share from struggling competitors). Conversely, they feel less exposed to downside risk based on the belief that they are investing close to the bottom of the economic cycle. We concur with these arguments, but recognize the risk in identifying cyclical troughs.

V. Deal Flow – Buyers and Sellers

Sellers

One of the questions we asked the GP sample was who the sellers are in their market currently. We wanted to get an idea of the amount of opportunities created by sellers in some form of stress or distress, as well as the existence in the current economic environment of other owners that would not normally sell companies (corporate divestitures, spinoffs etc.). We were also looking to support our thesis that deal flow in the lower middle-market, where ownership is generally entrepreneur/founder or family based, is more stable and consistent across cycles, and that growth and succession related issues will sustain the flow of companies coming to market. The responses we received are encouraging on all fronts. GPs are seeing a significant increase in opportunities from industrial and financial players in some sort of trouble. They are also seeing supply from corporations refocusing on core activities. Lastly, despite what has been said above about the gap between buyer and seller expectations, they are seeing supply from the traditional lower middle-market sources: entrepreneurs and families facing succession issues or a need for capital or management resources. The opportunities appear more diverse today than they were as recently as 12 months ago, and there are many reasons why owners are selling businesses. This is true for most European countries and we are not seeing a lot of difference from country to country in this regard. Some interesting and telling comments from the GP sample follow:

> *"We are seeing distressed corporates selling the family silverware. We bought a business last year in just that scenario. It is the leader in its market and is growing strongly. The parent was debt fuelled from having been on an acquisition spree and was forced to divest."*

> *"Clearly some companies took on too much debt and are being pressed by their banks to off-load assets, especially non-core ones. Some of these situations are not sufficiently distressed yet, but we expect more of them to come to market in H2 09."*

> *"Overleveraged private equity houses are looking for solutions by finding other investors to put more equity into businesses. For the most part these deals are not trading yet as private equity houses and lending syndicates are still in discussions."*

> *"Longer term growth ambitions are continuing to create opportunities to support growth and consolidation going forward. There are other situations where entrepreneur or family owned businesses have specific management issues and/or have simply grown too large for their ability to manage the company themselves."*

> *"Succession and generation shifts are continuing to create opportunities. We are positioning ourselves as active owners open to having the current owners onboard as minority owners going forward."*

> *"We expect the behavior of corporates to be much like every other cycle; buying when prices are too high and subsequently selling troubled businesses. We are seeing much more potential deal flow from distressed sellers today, with a lot of potential for add-ons."*

> *"The last deal we did was a corporate orphan being spun out of a very large corporate, but we are also seeing entrepreneurs, often in some form of stress, who are giving up and adjusting their expectations to new market levels. We expect the second half of 2009 to be more interesting from a deal flow perspective than the past six months."*

> *"In Central Europe we see some healthy businesses being forced to sell due to currency woes; mainly because they did not have currency hedges and their businesses had been set up to collect revenues in local currency while they had costs in Euros."*

Clearly, interesting distressed cases exist and are on the rise. As can be gleaned from the quotes above, these are not just complicated and time consuming turnaround situations where we might question the execution skills of a GP with only traditional buyout experience. Rather, they are often cases in which the seller is distressed and not necessarily the asset. Numerous corporate divestitures are also in evidence in the current environment, and we believe the private equity model is particularly well suited to these transactions. Of course, the need for succession or growth capital as well as the need for professional management upgrades remains the lifeblood of lower middle-market investing, and comments regarding these persistent themes were observed in the GP's responses.

Buyers

The feedback from the GP sample regarding buyers of companies in the European lower middle-market today is fairly uniform. Not surprisingly, a combination of strategic/trade buyers and financial sponsors are screening and closing deals today. The biggest change is the sharp reduction in transaction volume. There are countless tales of canceled, postponed and renegotiated deals, driven mainly by an inability to reach agreement on valuation and a general risk aversion and unwillingness to make the commitments needed for strategic acquisitions in the current environment.

Most lower middle-market GPs with cash on hand consider themselves active buyers of companies today. They also see other lower middle and middle-market private equity competitors in the market for the available deals. GPs reported that trade buyers are active, but these seem to be concentrated on certain industries and limited to large, sophisticated, well managed companies with a clear strategic vision. Trade buyers also need to be free from internal problems that take priority over new deals.

Interestingly, GPs reported that changes in competition were market specific. In the traditionally more competitive markets for private equity, such as the UK and Scandinavia, there are still quite a few funds pursuing lower middle-market deals, thereby keeping prices elevated. Conversely, in Germany, Switzerland, Italy and Spain, the GPs reported a significant reduction in competition. One telling comment we received from that area was the following:

> *"Transaction volume is clearly down. We see strategic players in some industries, and there are some funds out there ready to do deals. Many private equity players are closed for new transactions though, due to portfolio issues or the fact that deals are more complicated now and not everyone has the skill set required to close the ones that are in the market. Many groups are only suited to plain vanilla auctions and there are lots of young funds out there that are not equipped to handle more complex transactions. So there is less competition now. Even sellers see no point in starting large scale auctions. Instead they now prefer to call up and explain the difficulties associated with a certain deal, to determine if the private equity house is able and willing to deal with those particular challenges. In the past these same players had no interest in calling around. Instead they would start an auction and ask you to respond."*

Another theme that emerged, which seems logical given the environment, is that deals are taking longer in terms of due diligence, negotiation and closing. While pre-crisis transactions typically took about three months to consummate, the elapsed time today is more like nine to twelve months. Deals are also more likely to be tailored to the specific situation, rather than a formulaic package. Additionally, many established private equity managers, particularly larger ones, have portfolios with several companies in breach of covenants. Hence they are spending significant time and effort with these troubled companies, including bank negotiations and other restructuring measures, rather than on new investments. The positive side of longer execution times and less competition, as one GP told us, is that:

> *"We used to be able to secure exclusivity for two months when negotiating a transaction. Now it is easy to get much more. We like this because we can do more due diligence, which means less broken deal cost. We can get to know management better, and finally, we have longer time to track the performance of the target company. It also means that we can reduce our spend on auditors and lawyers, which is beneficial for our investors."*

VI. Current Market Observations

As they are on the frontline in terms of key themes and market developments we were very interested in the GP sample's views on the most interesting future investment opportunities. We also wanted to hear to what extent GPs are morphing their business models to adapt to a world where some believe the traditional buyout model is "dead," at least in the short term.

The feedback we received is that most of the GPs are not changing their business model at all. Instead they expect to continue executing the successful strategies they have developed over time. In most cases this means a focus on control acquisitions of entrepreneur or family-owned niche businesses, buy-and-build strategies and succession driven deals. Again, the ability to acquire small high quality companies facing succession issues and/or a need for capital or management resources is the "lifeblood" of the lower middle-market private equity segment and a consistent opportunity to generate attractive private equity returns across economic cycles. The GPs reported this channel is open and supplying them with interesting deals of the kind on which they have focused historically. Common themes for the various lower middle-market sub-strategies seem to be the expectation that the number of opportunities will increase going forward and the belief that we are entering a buyers market. For many GPs this is the case for the first time in a long while. Several of them have seen companies selling at abnormally high valuations over the past few years, and have reserved capital accordingly, whereas now they are seeing opportunities to invest at more sensible valuations. Consistent with past experience, GPs believe that lower middle-market investment opportunities will be deal specific rather than industry, sector or geography dependent, and self-sourcing will be mandatory as fewer transactions will be offered through auction processes.

Most GPs do expect valuations to fall further from their current levels. But they are engaging in discussions with sellers now, with the belief that the sellers' price expectations will converge with that of the buyers throughout the due diligence and negotiation processes. In terms of industry sectors, GPs are looking at buyouts in "recession proof" sectors as well as in more cyclical ones where the recession has been priced in.

As discussed previously, most GPs are seeing a marked increase in the number of "distressed" transactions coming to market. Some GPs are reporting attractive opportunities in the most desirable type of distressed investments – so called "good company, bad balance sheet" deals. In these transactions, the GP purchases a quality company with an overstretched balance sheet, often at a very attractive valuation, then merely capitalizes the company properly. Minimal heavy lifting from an operational perspective is required (in theory). Others are refraining from these deals as it usually involves asking existing shareholders and banks to take a haircut on the value of their holdings, and in a small, local market it can be more important to maintain good relationships with banks and other investors. Importantly though, we are not seeing GPs repositioning themselves as distressed specialists, in the sense that they are buying operationally troubled companies or attempting heavy turnarounds. Most of the GPs see no need to migrate their strategy in the current environment and recognize that they do not have the necessary skills or experience for such deals.

In line with the above we are not seeing much interest from the GP sample in entering deals through a company's debt. While they recognize the potential attractiveness of these more traditional distressed type transactions, the GPs also recognize the need for a specific skill set to successfully execute them, especially in the European context with a number of different legal systems and "cultural codes" to navigate. Although a few of the GPs mentioned public to private transactions at depressed valuations as an opportunity going forward, we expect this to be more of a focus for some of the larger European managers and not a focus in the lower middle-market.

Conclusion

While we recognize the need for some professional skepticism, overall we are encouraged by the feedback we received from the GP sample. Banks are still lending in the European lower middle-market (albeit with more conservative standards), and most GPs expect a gradual pick-up in transaction activity later in 2009. Moreover, it appears the newly rational credit markets are enforcing more rational purchase prices and capital structures on the private equity market – in many ways forcing it to return to its roots. We anticipate this trend will create a healthier environment for private equity and an opportunity to invest when capital is scarce and competition reduced. In our experience, these market characteristics have historically been reasonably good indicators of future success. Nevertheless, we believe successful buyout investing in the lower middle-market has always focused on the cause and effect relationship linking operational improvements to long term value creation. From our conversations with the GP sample they believe the opportunities to deploy such transformational changes to remain abundant. And encouragingly, most of them remain committed to following the business building strategies which have led to their success in the past.

List of contributing GPs that have agreed to be mentioned by name (out of 33 interviewed in total):

- Abénex Capital (France)
- Arx Equity Partners (CEE)
- Atlantis Capital Special Situations (Italy)
- Axcel Private Equity (Denmark)
- Bancroft Private Equity (CEE)
- CGS Private Equity (Switzerland)
- Cross Equity Partners (Switzerland)
- ECI Partners (UK)
- Gilde Buy Out Partners (Netherlands)
- Gresham Private Equity (UK)
- Halder (Germany)
- Investindustrial Advisors (Italy)
- Magnum Capital Industrial Partners (Spain)
- MCH Private Equity (Spain)
- Polaris Private Equity (Denmark)
- RJD Partners (UK)

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