



The insight: how Europe's private equity industry is anchoring long-term investors

Pan-European market sentiment survey

November 2021

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Authors:



Julien Krantz
Research Director
Invest Europe
julien.krantz@investeurope.eu



Guillaume Picq
Partner
Private Equity
Arthur D. Little, Paris
picq.guillaume@adlittle.com



Jonas Fagerlund
Partner
Leader Global Private Equity
Arthur D. Little, Stockholm
fagerlund.jonas@adlittle.com

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Introduction

The European private equity industry has been resilient in the face of great disruption – and thanks to that resilience has imbued fund managers and investors with greater confidence about the future.

Invest Europe's data for the first half of 2021 shows a remarkable rebound from the same period of last year. Private equity investment levels reached a new high in the first half, putting the industry on track for another strong year and potentially new records in 2021. Fundraising is in line with the high levels achieved in recent years, while exits have improved and similarly echo recent averages.

Far from simply embracing a return to business as usual, the responses from our market sentiment survey indicate that private equity is also treading a new path. The pandemic has had many clear and negative impacts on people and communities, but it has also driven positive change in the businesses. For example, new flexible ways of working for staff and the move to greater digitalization at great speed, which will help build a more innovative and competitive Europe on the world stage.

The greatest shift – and a theme that runs throughout the survey – is increased focus on environmental, social and governance (ESG) factors. From more attention by General Partners (GPs) and Limited Partners (LPs) to ESG in their day-to-day operations, to greater importance placed on ESG risks and opportunities in due diligence, private equity firms are embracing more sustainable and responsible investment.

As a long-term investor, private equity is a cornerstone of the European economy. Having provided support for businesses through the recent downturn, the industry is providing capital and direction for companies in the recovery. The aim is stronger, more resilient businesses that support growth and transformation across Europe and contribute to a better society long term.

This report is based on a pan-European survey that was conducted by Invest Europe and Arthur D. Little during the months of July and August 2021.

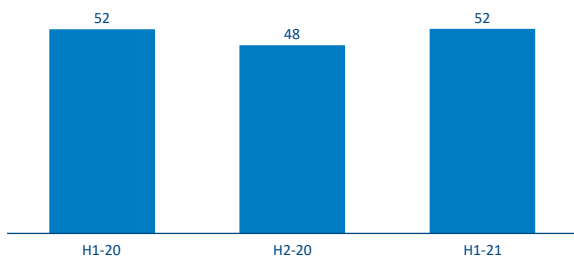
It consolidates the outcomes from 100 Limited Partners (LPs) and 150 General Partners (GPs) across geographies. LP and GP respondents represent the private-industry diversity in Europe in terms of geographical footprint, industry sectors covered and investment strategy/stage.

This publication also integrates extracts from Invest Europe's report "Investing in Europe: Private Equity Activity H1 2021", issued in November 2021.

1. Improved fundraising environment for private equity

Private equity continues to be highly sought after by investors who want to deliver better pensions and returns to European savers. European fundraising hit €52.4 billion in the first half of 2021, following on from the industry’s resilient result in 2020. A total of 365 funds completed fundraising between January and June, the highest number ever recorded for a first half.

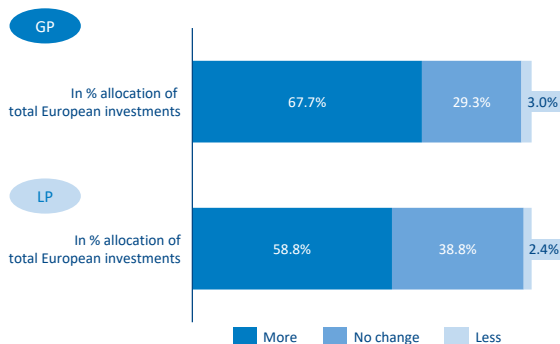
Figure 1: Funds raised by European Private Equity and Venture Capital funds (€bn)



Source: Investing in Europe: Private Equity Activity H1 2021, Invest Europe

Over two-thirds of General Partners expect allocations to private equity to increase over the next three years, with private equity accounting for a larger percentage share of European investment portfolios. That anticipated support is a clear reflection of private equity’s belief in its ability to deploy capital into attractive company investments across Europe.

Figure 2: Capital allocations to Private Equity asset class next 3 years



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

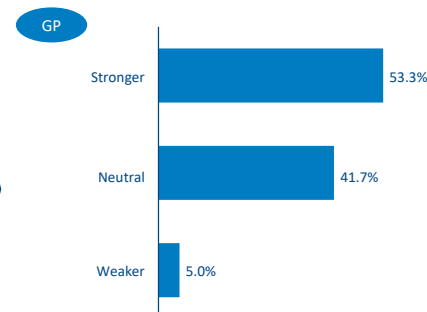
Limited Partners are also strongly positive about future capital allocations. Almost 60% expect private equity to account for a higher percentage share of European investments over the next three years. That result confirms the asset class’s appeal in the face of the persistently low interest rate environment in Europe, as well as the industry’s expanding reach via new funds and strategies that are taking private equity to a wider audience of professional and retail investors. Only a small number of both GPs and LPs expect private equity allocations to be less.

The medium-term outlook is echoed in the near-term capital flow expectations. Over half of GPs believe that fundraising will be stronger in the next 12 months, compared with the previous 12 months. Only 5% believe that it will be weaker.

“We have seen private equity perform resiliently throughout cycles. In fact we have seen increasing outperformance to public equities in turbulent markets. As a result we expect investors to continue to allocate relatively more capital to the asset class in uncertain times.”

Elias Korosis, Partner, Hermes GPE

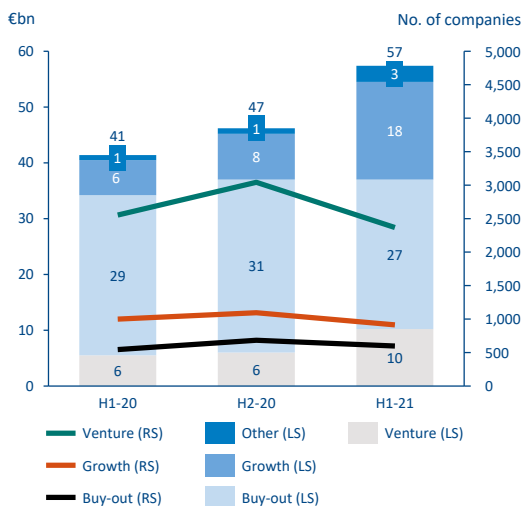
Figure 3: Fundraising next 12 months vs. last 12 months



2. Strengthening belief in investment opportunities

Investment activity in Europe strengthened in the first half of 2021, hitting a new six-month high of €57 billion and cementing a strong recovery from the first half of 2020. There were record totals for both growth and venture investment as GPs directed more capital towards innovative, fast-growing companies.

Figure 4: Investments by stage in value and volume

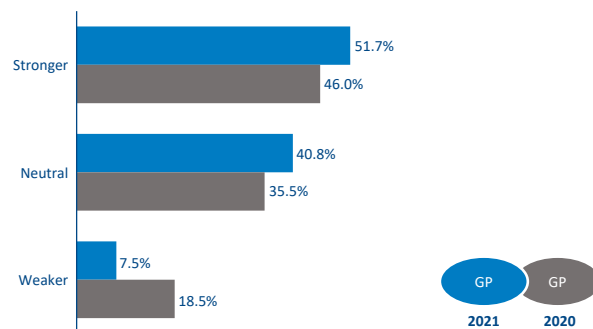


Source: Investing in Europe: Private Equity Activity H1 2021, Invest Europe
Note: LS = Left scale; RS = Right scale

As investment has rebounded, private equity firms are more confident about their ability to identify companies that they can transform and grow with their capital and expertise. Over half of GPs believe the outlook for finding investments will be stronger over the coming 12 months – an increase from 46% last year. Similarly, a larger number of GPs are neutral on the prospects, while the proportion who believe the outlook is weaker is sharply reduced from 18.5% to 7.5%.

Sectors at the cutting edge of technology and health remain among the most attractive and in demand among private equity firms. Life science & healthcare has become the top target sector with three-quarters of GPs expecting investment to be more frequent in the space over the coming 12 months. Renewable energy has also accelerated – reflecting increased attention to ESG issues found throughout our survey – with around six out of ten GPs expecting investment to be more common.

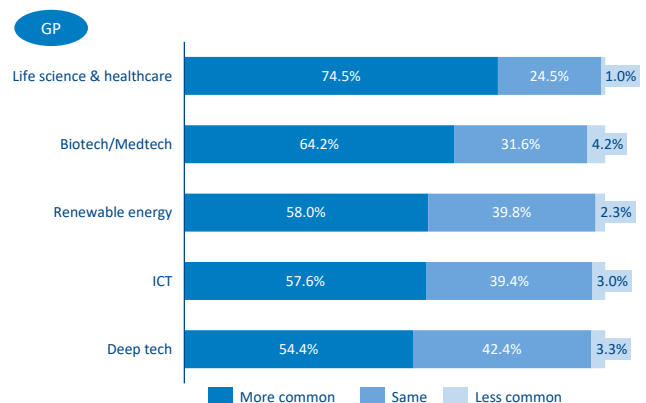
Figure 5: Perception of investment opportunities in the market within the next 12 months compared to the last 12 months



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

Interest in themes across technology and health remains strong. Following on from an active first half in which the ICT sector accounted for 37% of all investment, and biotech & healthcare drew 18% of the total, more than half of GPs expect increased investment in biotech & medtech, ICT and deeptech during the coming year.

Figure 6: Expected investment operation activity levels per top 5 target sectors compared to the last 12 months



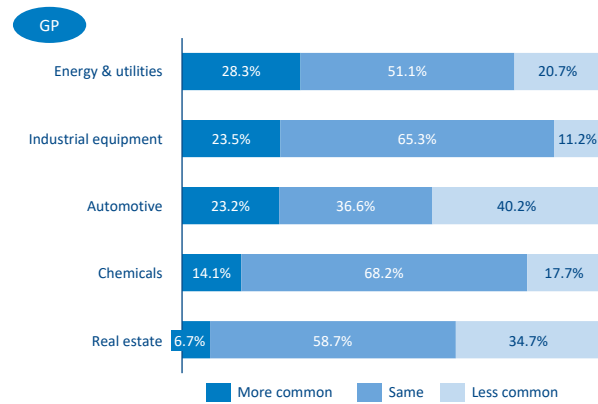
Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

“Compared to last year, we see increasingly more opportunities in the life science and healthcare sector, as well as industries related to renewable energy.”

George Swirski, Co-Founder & Chairman, Abris

At the other end of the spectrum, utilities, chemicals, and real estate are still viewed as less attractive, with fewer GPs than last year expecting investment to rise in those sectors. However, some segments have seen a bounce in interest levels from last year, most notably automotive with almost a quarter of GPs expecting more investment activity versus one in ten a year ago.

Figure 7: Expected investment operation activity levels per 2021 bottom 5 target sectors compared to last 12 months

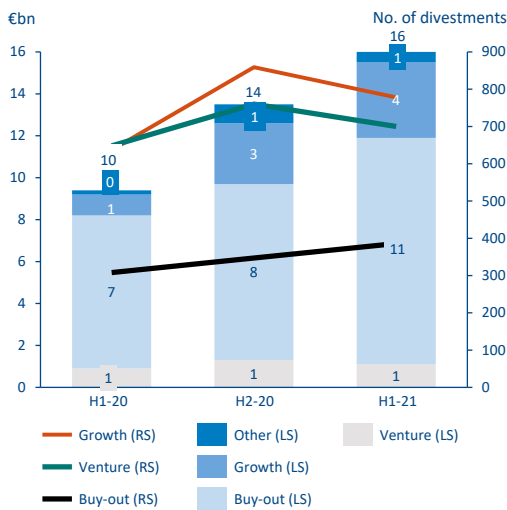


Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

3. Divestment outlook supports a stronger private equity market

First half divestments increased to €16 billion (measured at original investment cost), enabling GPs to crystalize investment gains and provide LPs with capital that can ultimately flow back into new private equity funds.

Figure 8: Divestments of European companies by private equity & venture capital funds focused on Europe



Source: Investing in Europe: Private Equity Activity H1 2021, Invest Europe
Note: LS = Left scale; RS = Right scale

Following the recovery in divestment activity from the lows of early 2020, GPs expect a significantly improved exit outlook over the coming year. In sharp contrast to over half of respondents who expected a weaker divestment outlook 12 months ago, almost two-thirds of GPs expect stronger divestment of companies over the next year. That flow of exits will signal opportunities for other investors, potentially increasing the supply of companies for other private equity firms to buy and take to the next stage of their development.

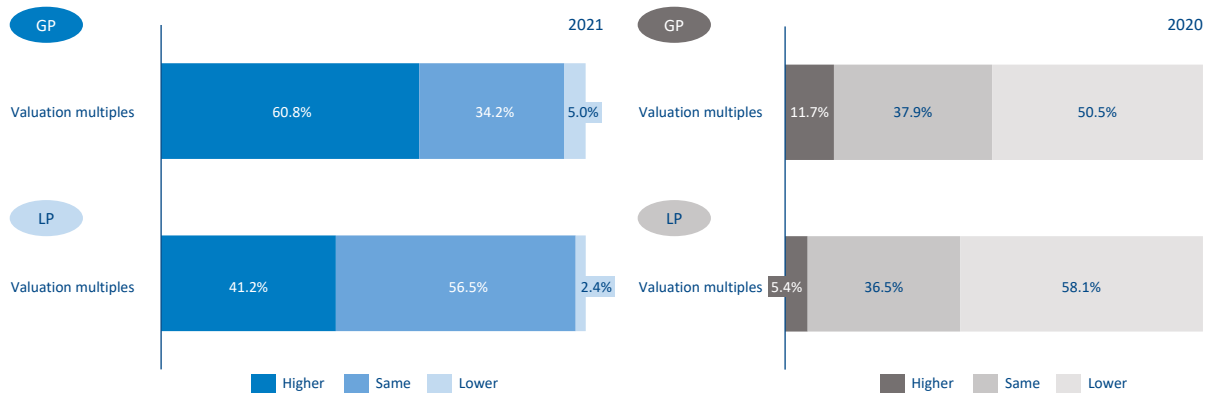
Higher asset prices are helping fuel exit optimism, enabling private equity firms to consider bringing assets to market. Over 60% of GPs expect valuation multiples to increase over the next 12 months, more than five times higher than last year's response. LPs are less confident about rising valuations, with more than 40% believing asset prices will be higher, but similarly are significantly more optimistic than last year.

Figure 9: Expected changes in divestment of portfolio companies over the next 12 months compared to the last 12 months



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

Figure 10: Evolution of PE transaction market in the next 12 months compared to the last 12 months by activity



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

“During COVID-19 last year, there was a great deal of uncertainty weighing on companies. Much of that uncertainty has now lifted and, as a result, valuation multiples have risen.”

Dariusz Pietrzak, Vice President, Enterprise Investors

That confidence is also evident in the belief that traditional exit routes will improve, with over half of GPs expecting that auctions will be more common over the next 12 months, more than double last year’s reading. A similar number of GPs think that IPOs will be more common over the coming year, a clear reversal of last year’s survey when 50% of respondents believed that stock market listings for portfolio companies would be less common.

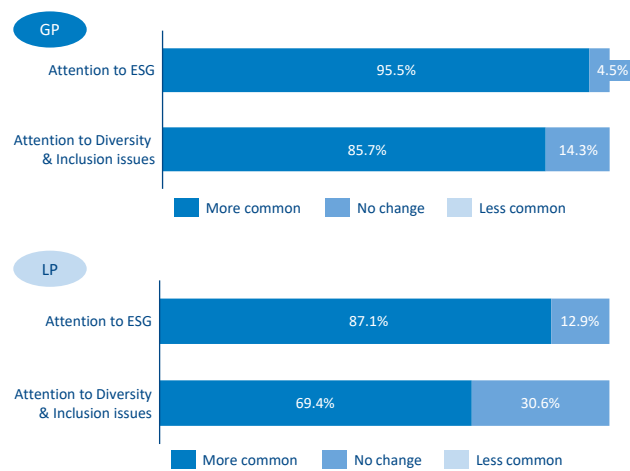
4. ESG and impact investing are on the rise

As attention has switched from managing businesses through the pandemic to fueling a sustainable economic recovery, both private equity firms and their investors are putting increased focus on the industry’s role at the cornerstone of the European economy and its potential to contribute to a better society.

Almost all GPs (95.5%) and nearly nine out of ten LPs expect attention on environmental, social and governance (ESG) considerations to become more important in the near future. Similarly, both fund managers and investors are looking closely at issues of gender equality and diversity across the industry and the companies it supports.

Social and environmental factors are increasingly embedded into GP investment practices, as well as their funds. More than seven out of ten GPs stated that they follow the ESG criteria outlined by Article 8 of the Sustainable Finance Disclosure Regulation. Almost 20% stated that they are going even further by aligning with the stricter criteria for Article 9 of SFDR and making sustainable investment or a reduction in carbon emissions objectives of their funds.

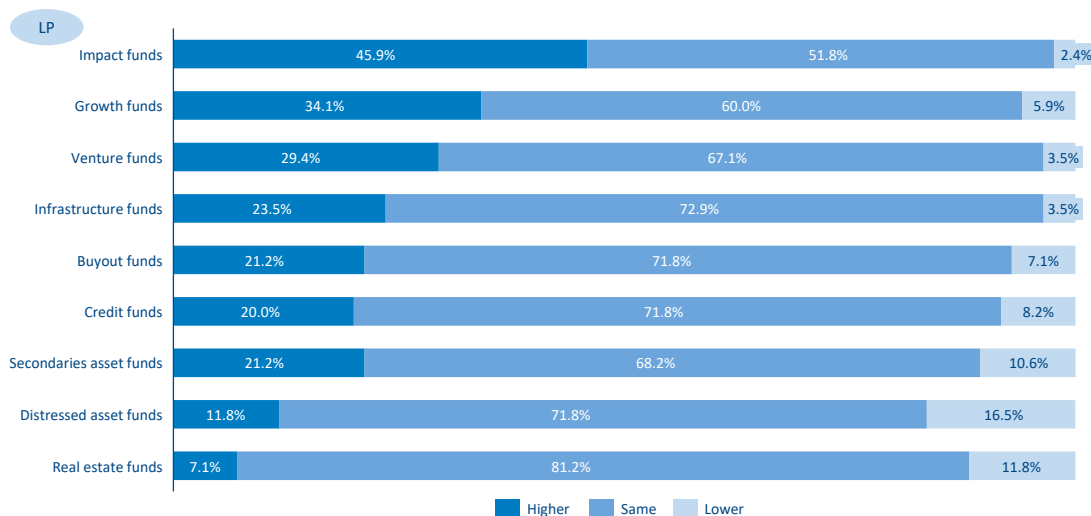
Figure 11: Expected changes in GPs’ daily operations/how LPs manage allocated capital towards PE asset class in the near future



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

GPs’ positioning on ESG echoes rising demand among investors for the funds they back to deliver positive social and environmental contributions. Almost half of LPs expect to make a higher allocation to impact funds in their investment strategies over the next 12 months.

Figure 12: Expected changes in investment strategy allocations over the next 12 months compared to the last 12 months



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

While the majority of LPs expect to continue their investment approaches as before, a significant proportion are looking to commit more capital to growth funds (34.1%) and venture funds (29.4%) over the next 12 months, an endorsement of Europe's improving track record in nurturing the tech and biotech start-ups and scale-ups that are laying the groundwork for a better future.

“It’s encouraging to see the industry’s increased focus on ESG matters. To be at the forefront and contribute to the solutions society needs, we must embrace diversity, enhance transparency and strive at achieving positive real-world impact across everything we do.”

Therése Lennehag, Head of Sustainability, EQT

5. Impact of COVID-19

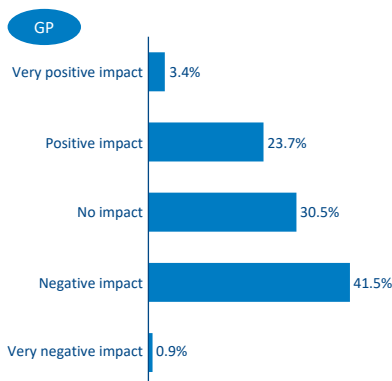
COVID-19 had an immediate effect on individuals and businesses as governments across Europe imposed restrictions to curb the rise in cases. Private equity responded rapidly with measures to ensure that portfolio companies had liquidity and enough support to weather the immediate shock, before devising plans to enable companies to recover and grow over the medium-to-longer term.

The result was a wide range of impacts on GP funds. Roughly four in ten GPs said that the pandemic had a negative impact on fund performance, although under 1% claimed the impact was very negative.

Conversely, a sizeable proportion – over one-quarter – reported that the pandemic had a positive or very positive impact on fund performance. The findings appear to mirror broader market trends, which have seen some companies, in sectors such as leisure, consumer goods and travel, hit hard by physical restrictions, while others in areas including e-commerce and software have witnessed increased sales and profits from changes in behavior and consumption.

That shift is helping to drive private equity firms to increase their focus on key transformation themes, such as investment in technology, as we will see in section 6.

Figure 13: Impact of COVID-19 pandemic on overall performance of GP fund



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

“From a certain perspective, the pandemic has made us take positive steps to strengthen our companies. The most obvious aspect is that the digitalization efforts that began before COVID have accelerated, putting us 2-3 years ahead of where we would have expected to be.”

Louis Godron, Managing Partner, Argos Wityu

6. Strong momentum in business transformation in portfolio companies

Evolving understanding of social and environmental risks is shaping how private equity firms analyze investment opportunities. Almost six GPs in ten expect to change how they conduct due diligences, and of those, a similar proportion intend to focus more on ESG issues – reflecting findings that show GPs intend to put more attention on ESG in daily operations and promote more social and environmental considerations in their funds.

Digitalization maturity and cybersecurity will also receive significantly more focus as GPs pay greater attention to both the opportunities and threats that technology can bring for companies across a wide range of sectors.

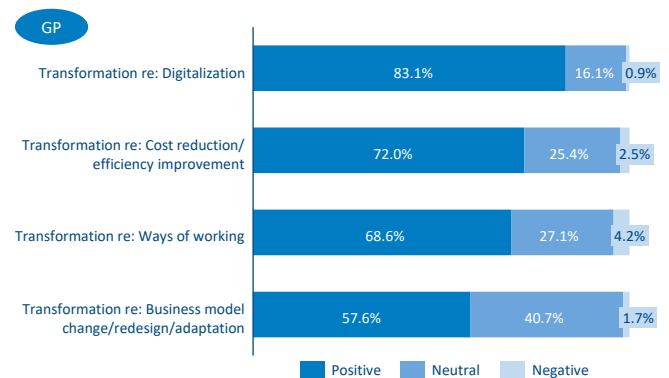
Figure 14: Due Diligence assessments that will receive more attention¹



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021
 Note: 1) Multiple choices were possible, and only GPs that answered "Yes" in the question illustrated in the graph above

In keeping with the positive – or at least neutral – impact of COVID-19 on funds, GPs tell of positive influences on the development of portfolio companies across a number of fields. Most have witnessed significant improvements coming from new working practices initiated as a result of the pandemic and the drive to greater company efficiency. However, the greatest number of GPs (83.1%) report positive impact from digital transformation.

Figure 15: Overall transformation impact of COVID-19 on portfolio companies by selected areas

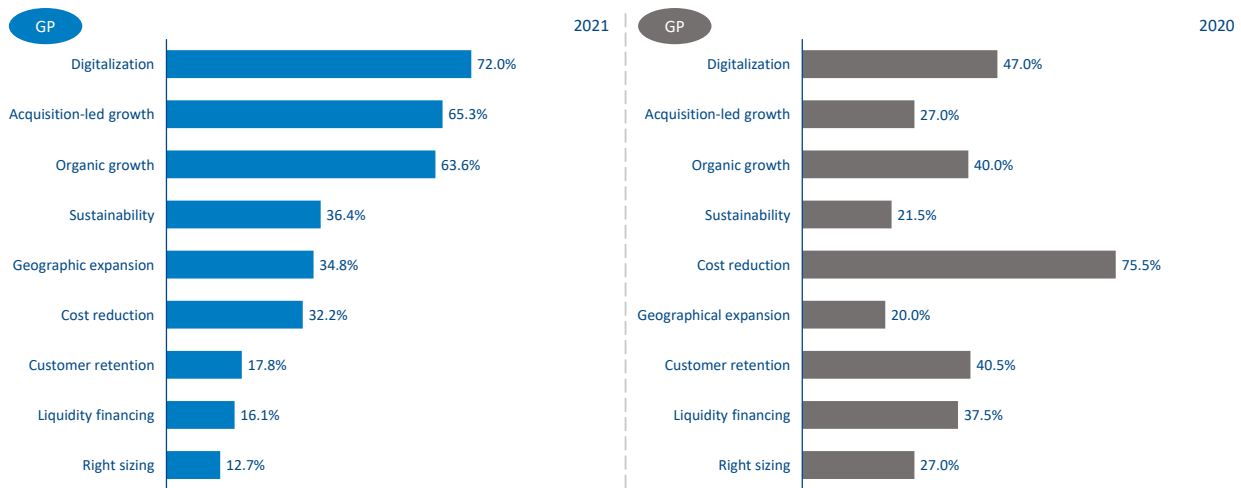


Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021

The focus on digitalization carries through to current operational improvement programs at portfolio companies, with 72% of GPs running digital initiatives to boost their businesses. Growth via acquisitions and organic increases in sales are considered the next most important initiatives, while the focus on sustainability has also increased sharply, with over a third of GPs looking at such measures to drive growth.

In contrast, measures aimed at making returns out of business restructuring have reduced significantly. Cost-reduction measures have fallen from being an important initiative for by far the largest number of GPs in 2020 to sixth place in 2021, which is most likely also a result of COVID-19 as many companies were forced to scale down their operations during the pandemic.

Figure 16: Most important improvement initiatives being run in portfolio companies at the moment¹



Source: Arthur D. Little analysis and Invest Europe Private Equity survey 2021
 Note: 1) Multiple choice answers were available



7. Conclusion

European private equity is adaptable, resilient, and innovative. This message emerges loud and clear in the first half data and the survey responses of fund managers and investors. The industry has come through a challenging period for the global economy with higher-than-ever levels of investment, robust fundraising, and an improving outlook for divestments. Recent activity, combined with a long track record of performance through periods of economic growth and recession, has elevated private equity in many investors' eyes. As a result, allocations are expected to grow, with the asset class likely to command a larger proportion of the portfolios of pension funds, insurers, endowments, and other long-term investors in the future.

Increased investment activity has raised valuation expectations, mirroring higher multiples seen for listed equities. However, pricing levels are not dampening private equity appetite. Instead, GPs are looking to new value creation strategies to drive growth and profitability at portfolio companies. While cost reduction was the top prioritized initiative for GPs last year, it dropped to sixth place in this year's survey. Instead, the leading priority is digitalization as managers invest in technology to add value.

Another theme that runs through our survey, and which is clearly at the forefront of both GPs' and LPs' minds, is ESG. Private equity is focusing more on ESG activities in day-to-day operations and is increasingly putting social and environmental considerations at the heart of due diligence processes. And more investors want to commit to funds that deliver tangible benefits for people and the planet alongside investment returns. ESG is a trend that Europe is leading, and that the European private equity industry is committed to supporting.

Understanding risks and identifying opportunities is at the core of what European private equity does. As a result, private equity firms build better businesses that are not only resilient to economic shocks, but which also benefit from the long-term secular trends that are shaping the European – and global – economy.



Contacts

If you would like more information or to arrange an informal discussion on the issues raised here and how they affect your business, please contact:

Austria

Lars Riegel
riegel.lars@adlittle.com

Japan

Hiroto Suzuki
suzuki.hiroto@adlittle.com

Singapore

Tomasz Izydorczyk
Izydorczyk.Tomasz@adlittle.com

Belgium

Gregory Pankert
pankert.gregory@adlittle.com

Korea

Kevin Lee
lee.kevin@adlittle.com

Spain

Pedro Ugarte
ugarte.pedro@adlittle.com

China

Mark Peacock
peacock.mark@adlittle.com

Latin America

Guillem Casahuga
casahuga.guillem@adlittle.com

Sweden

Jonas Fagerlund
fagerlund.jonas@adlittle.com

Czech Republic

Jiri Steif
steif.jiri@adlittle.com

Middle East

Dhiraj Joshi
joshi.dhiraj@adlittle.com

Switzerland

Maximilian Schauer
schauer.maximilian@adlittle.com

France

Guillaume Picq
picq.guillaume@adlittle.com

The Netherlands

Martijn Eikelenboom
eikelenboom.martijn@adlittle.com

Turkey

Utku Oz
oz.utku@adlittle.com

Germany

Maximilian Schauer
schauer.maximilian@adlittle.com

Norway

Lars Thurmann-Moe
thurmann-moe.lars@adlittle.com

UK

Enguerran Ripert
ripert.enguerran@adlittle.com

India

Barnik Maitra
maitra.barnik@adlittle.com

Poland

Piotr Baranowski
baranowski.piotr@adlittle.com

USA

Sean McDevitt
mcdevitt.sean@adlittle.com

Italy

Andrea Romboli
romboli.andrea@adlittle.com

Russian Federation

Alexander Ovanesov
ovanesov.alexander@adlittle.com



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