Private Equity Trend Report 2023
Battling through the headwinds
Preface 2023

Dear friends,

What a ride 2022 has been – just when we thought that we had returned to a long-awaited normality post pandemic, this was put to a sharp halt through Russia’s invasion of the Ukraine. The ensuing soaring inflation, uncertainty of energy availability and further disruption of already fractured supply chains impacted many European countries. Having had it almost “too good” for a decade, constant interest rate hikes have been a burden on businesses and all of society as governments have desperately tried to combat inflation.

Investors entered 2022 on a high. Within private equity, investment activity worldwide breached $1 trillion for the first time in 2021, and all buyout and venture capital fund managers were expecting 2022 deal activity to at least keep this pace. However, the era of cheap money, low inflation, predictable prices of raw materials, abundant financing opportunities and unstoppable economic growth now appear to be officially over. Uncertainty and volatility have only intensified with macroeconomic challenges putting additional pressure on returns, making it once again even more necessary for GPs to focus on their portfolio and drive deep value creation.

After the record-breaking prior year, 2022 had a solid start but by mid-year had cooled down significantly. While deal activity dropped by 19% YoY, it is worth noting that deal volume is still above 2018 levels and deal value only 1% below 2021. The main driver here was certainly not the availability of dry powder, but rather the tightening in financing availability from banks, with the syndicated loan markets being all but shut to large leveraged buyouts for much of this time.

One thing is becoming ever more apparent: the long-term opportunity private equity presents may currently be bigger than the traditional sources of capital can support. Fundraising has become much more challenging than we have seen for some time as LPs are at the limits of their allocations to this sector and have become necessarily more selective, with all but the large-cap funds having to fight much harder for the available fresh capital. To partly combat this, we are seeing many industry players expanding relationships with LPs such as the massive sovereign wealth funds to establish committed co-investment pots.

Many have been using the current quieter deal flow to focus heavily on their portfolio companies, partially from a value creation perspective considering the inflationary pressures, but also to have a (possibly overdue) hard look at older fund vintages, working on and exiting long-held investments through various channels. Such successful exits clearly assist with fundraising in this more challenging environment.

Looking forward to 2023 and beyond, the outlook for the private equity industry in Europe is mixed. On one hand, the industry will continue to face the challenges of the ongoing macroeconomic headwinds, turbulence in the banking and financing markets, recession fears and energy price uncertainty. On the other hand, private equity firms have historically shown remarkable resilience and adaptability regardless of external events. The coming years will see yet another transition as
asset prices react to reduced growth combined with a higher cost of capital and waning market confidence. While volatility does bring uncertainty, it also provides opportunity and with continued record levels of dry powder, the sector will likely continue to creatively find new opportunities for growth and success. For example, it is evident that most businesses will need to undergo a fundamental transformation over the next decade in order to survive, whilst at the same time addressing major ESG challenges. These come with significant short-term investment requirements that will need both fresh capital and expertise - private equity can clearly play a major role in this.

We firmly believe that the current situation offers significant opportunity on many levels. It will obviously not be an easy ride and there are many obstacles and challenges to come, however, the industry may well never have been so well positioned to benefit from these and continue to make a major contribution both economically and socially to the solutions required.

As always, our thanks go to all those who participated in this year’s survey and shared their opinions. We look forward to working with you again in 2023 and beyond!

Steve Roberts
Private Equity Leader
# Table of Contents

**Table of Figures** ...................................................................................................................... 5

**A. Introduction** .................................................................................................................... 8

**B. Market Overview** ........................................................................................................... 10

  - Private Equity in Europe .................................................................................................................. 11
  - Buyout trends .................................................................................................................................. 11
  - Exit trends ....................................................................................................................................... 13
  - Geography of European deals ............................................................................................................ 14
  - Industry focus ................................................................................................................................. 15
  - Deep dive: DACH spotlight ............................................................................................................. 17
  - Deep dive: Benelux spotlight .......................................................................................................... 19

**C. Key Findings** ....................................................................................................................... 22

**D. Detailed Findings** ................................................................................................................. 25

  - Part 1: 2022 in review ..................................................................................................................... 26
  - Part 2: The year ahead .................................................................................................................... 33
  - Part 3: Operational improvements, value creation and digitisation .................................................. 41
  - Part 4: ESG and responsible investing ........................................................................................... 50
  - Part 5: Zooming in on Germany .................................................................................................... 55

**E. Methodology** ....................................................................................................................... 58

**Appendix** ................................................................................................................................ 60
# Table of Figures

| Fig. 1 | European Private Equity Trends 2017–2022 | ................................................................. | 11 |
| Fig. 2 | European Buyout Trends 2017–2022 | ................................................................. | 12 |
| Fig. 3 | European Buyouts, Split by Deal Size, 2017–2022 | ................................................................. | 13 |
| Fig. 4 | European Exit Trends 2017–2022 | ................................................................. | 14 |
| Fig. 5 | European Buyout Volume, Split by Regions 2021–2022 | ................................................................. | 15 |
| Fig. 6 | European Buyout Value, Split by Regions 2021–2022 | ................................................................. | 15 |
| Fig. 7 | European Buyout Volume, Split by Sector 2017–2022 | ................................................................. | 16 |
| Fig. 8 | European Buyout Value, Split by Sector 2017–2022 | ................................................................. | 17 |
| Fig. 9 | DACH Private Equity Trends, 2017-2022 | ................................................................. | 18 |
| Fig. 10 | DACH Private Buyout Trends, 2017-2022 | ................................................................. | 18 |
| Fig. 11 | DACH Buyout, Split by Deal Size, 2017-2022 | ................................................................. | 19 |
| Fig. 12 | DACH Exit Trends, 2017-2022 | ................................................................. | 19 |
| Fig. 13 | Benelux Private Equity Trends, 2017-2022 | ................................................................. | 20 |
| Fig. 14 | Benelux Buyout Trends, 2017-2022 | ................................................................. | 20 |
| Fig. 15 | Benelux Exit Trends, 2017-2022 | ................................................................. | 21 |
| Fig. 16 | Compared to 2021, has the number of potential transactions which you have reviewed in an average month this year increased or decreased? | ................................................................. | 26 |
| Fig. 17 | Compared to 2021, has the number of new investments made by your organisation this year increased or decreased? | ................................................................. | 27 |
| Fig. 18 | How has the conflict in Ukraine in 2022 impacted the number of new investments of your organisation? | ................................................................. | 27 |
| Fig. 19 | Compared to 2021, would you say that competition for investments among private equity firms has increased or decreased? | ................................................................. | 28 |
| Fig. 20 | Compared to 2021, has the number of exits made by your organisation this year increased or decreased? | ................................................................. | 29 |
| Fig. 21 | How has the conflict in Ukraine in 2022 impacted the number of exits of your portfolio companies? | ................................................................. | 29 |
| Fig. 22 | How satisfied or dissatisfied are you with the development of your portfolio companies in 2022? | ................................................................. | 30 |
| Fig. 23 | Looking back at 2022 and the effects of the conflict in Ukraine, which of the following have had the strongest impact on your firm as well as your portfolio? (Please select top two) | ................................................................. | 30 |
| Fig. 24 | Have expectations and requirements of your limited partners (LPs) changed during the prior three years? | ................................................................. | 31 |
| Fig. 25 | If your expectations and requirements of your limited partners (LPs) have increased during the prior three years, which of the following best describe the changes in expectations and requirements? (Please rank top three, where 1 = biggest change) | ................................................................. | 32 |
| Fig. 26 | Compared to 2022, do you expect the number of new investments made by your organisation in 2023 to increase or decrease? | ................................................................. | 33 |
Fig. 27 Compared to 2022, do you expect the number of exits made by your organisation in 2023 to increase or decrease? .................................................................34

Fig. 28 How do you expect the European deal market for private equity to develop in 2023? Do you think it will get better or worse? .................................................................................................35

Fig. 29 How do you expect the world economic situation to develop in 2023? .................................................................................................................................35

Fig. 30 Looking forward to 2023 and the effects of the conflict on Ukraine, which of the following do you expect will have the strongest impact on your firm as well as your portfolio? (Please select top two) ...........................................35

Fig. 31 Looking forward to 2023, which of these factors do you consider will influence equity stories on acquisitions for your organisation? (Please select all that apply and the main factor) ........................................................................36

Fig. 32 In your opinion, which, if any, of these will be sources of new deal opportunities for your organisation in 2023? .........................................................................................................................37

Fig. 33 In your opinion, which of the following industries is your organisation most likely to invest in over the next 2 to 3 years? Please name a maximum of 3 industries. (Please choose up to three) – Top answers shown...37

Fig. 34 What percentage of your portfolio companies broke one or more bank covenants, or otherwise need to enter negotiations with their financing providers in 2022 and how many do you expect will break one or more in 2023? .............................................................................................................38

Fig. 35 Looking back on the returns on investments you made during the past five to seven years have they been / are they expected to be higher or lower than expected? .................................................................39

Fig. 36 Looking forward towards the expected returns on investments made during the past year, how do these compare to the returns on investments made five to seven years ago? .................................................................................................39

Fig. 37 Again looking ahead, what are the key issues which the private equity industry in Europe will face in the next 5 years? (Please rank top three, where 1= most important issue) .................................................................40

Fig. 38 Please rank the following in terms of importance, regarding their influence on your return on investment. (Please rank 1 to 4, where 1 is the most important and 4 is the least important) – Rank 1 and 2 shown only 42

Fig. 39 During the past three years, has the impact of operational improvements (excluding digitisation), multiple arbitrage, financial leverage and digitisation on your return on investment increased, decreased or stayed the same? .................................................................................................................................42

Fig. 40 Looking forward, do you expect the impact of operational improvements (excluding digitisation), multiple arbitrage, financial leverage and digitisation on your return on investment to increase, decrease or stay the same? .........................................................................................................................42

Fig. 41 Which levers are most important to value creation within the equity / investment story? (Please rate each on a scale from 1 to 10: 1 being “least important” and 10 being “most important”) ..................................................44

Fig. 42 Has the importance of value creation levers changed the way you look at new investments and do you model it into your equity story already at entry / during the due diligence phase? .................................................44

Fig. 43 How do you expect the importance of value creation to develop in the future? .................................................44

Fig. 44 How would you rate the level of impact from digital transformation on the following elements of your company business model? (Rate from 1 to 10, 1 impacted least, 10 impacted most) .................................................45

Fig. 45 To what extent do you believe that the level of digital transformation is important to the future exits from your current portfolio companies and the subsequent return to be achieved? .................................................46
Fig. 46  Have you made investments in digitally transforming your own firm or portfolio company business models in the past year? ..............................................................47

Fig. 47  If so, in which of the following areas of digital transformation have you focused your investment? ..........47

Fig. 48  In which of the following areas of the investment cycle has your organisation used data analytics in 2022? ........................................................................................................48

Fig. 49  In which of the following areas of the investment cycle do you anticipate your organisation will use data analytics in 2023? ........................................................................................................48

Fig. 50  Will you be investing in digitisation over the next year? ......................................................................48

Fig. 51  If you plan to invest in digitisation over the next year, in which of the following areas will you be investing? 49

Fig. 52  Does your firm have a responsible investing or ESG policy and the tools to implement it? ..................50

Fig. 53  Are ESG value levers a core part of your value creation story when assessing buy-side opportunities? ....51

Fig. 54  Do you set ESG specific KPIs for your portfolio companies and monitor these on a regular basis? ........52

Fig. 55  Do you believe the return on ESG investment exceeds the cost? .........................................................52

Fig. 56  Please rank the following areas of responsible investing in their importance to you from 1 (most important) to 8 (least important) - Ranks 1 and 2 shown only ........................................53

Fig. 57  Which one of the following is the main focus of your investments and portfolios? ............................54

Fig. 58  Does your firm currently have any investments such as portfolio companies in Germany? ..................56

Fig. 59  Do you plan to continue making investments in Germany over the next five years? ..........................56

Fig. 60  Do you think that the assets that you allocate to Germany over the next five years will increase or decrease? .....................................................................................................................................56

Fig. 61  In an international comparison with other countries, how would you assess the attractiveness of Germany as a location for private equity investment? ......................................................57

Fig. 62  In your opinion, which countries or regions will become more attractive for private equity investments over the next five years? – Top 10 answers shown only ........................................57

Fig. 63  In which country is your organisation’s headquarters based? ..............................................................59

Fig. 64  Which of the following best describes your firm’s current total global fund volume (i.e. capital under management)? ........................................................................................................59

Fig. 65  In your opinion, which of the following industries is your organisation most likely to invest in over the next 2 to 3 years? Please name a maximum of 3 industries. (Please choose up to three) ........................................60

Fig. 66  Please rank the following in terms of importance, regarding their influence on your return on investment. (Please rank 1 to 4, where 1 is the most important and 4 is the least important) – Rank 1 and 2 shown only ......................................................60

Fig. 67  Please rank the following areas of responsible investing in their importance to you from 1 (most important) to 8 (least important) .........................................................................................................61

Fig. 68  In your opinion, which countries or regions will become more attractive for private equity investments over the next five years? .....................................................................................................61
A. Introduction
The European private equity (PE) industry has endured a more challenging 12 months than was expected at the start of 2022. At the time, the industry had just celebrated its busiest year to date, but there were signs of change on the horizon.

With the invasion of Ukraine, the world was turned upside down—again. Having survived—and in some cases, thrived—during the economic uncertainty of the pandemic, PE firms were suddenly facing rising inflation and interest rates were sent higher on the back of surging energy costs. And yet the European PE market put on an exceptional display, investment coming in above pre-pandemic levels.

However, there are some important distinctions to be made. Although dry powder levels remain high, fundraising was down last year, and deal activity was markedly weaker in the second half of 2022 than during the first six months. Syndicated loan markets were all but shut to large leveraged buyouts for much of this time, resulting in deal value underperforming volume in some regions. And mega deals still took place – irrespective of the tightening in financing.

Under these conditions, the mid-market has been a port in a storm. Smaller general partners (GPs) have been able to finance their transactions with banks and direct lending funds, albeit at higher costs. Now is the time for sponsors to focus on what they do best—buying companies and making them higher-performing businesses. Whether through add-ons, operational improvements or digitisation, PE funds will now be relying on their core skillset to generate returns for their investors.

Those surveyed for this report widely point to these being the most important value levers at this time. Whether Europe manages to avoid a recession or not, PE firms will be sharpening their tools and working closely with company management teams to accelerate their growth. It’s a challenge the industry has risen to before, and it will do so again.
B. Market Overview
Private Equity in Europe

European PE saw a pronounced downtrend in the second half of 2022. Both deal volume and deal value remained well below pre-pandemic levels in this time period. PE volume was down by 19% year-on-year (YoY) to 2,548 transactions. However, deal value remained stable only declining slightly by 1% YoY to €214.8bn. The downtrend in Europe was due to the war in the Ukraine, coupled with a general recession fear, soaring inflation and thus a slowdown in PE markets and the fact that dealmaking roared to all-time highs in 2021 after the short pause markets took in 2020.

Buyout trends

A declining trend was also seen in buyout volume, as sponsors took a more guarded approach to their capital deployment in the latter half of the year. There were 1,011 buyouts in 2022, a 24% fall YoY. Large-cap sponsors found that syndicated loan markets became far less permissive as investors grew concerned about overexposing themselves to leveraged debt in sectors prone to inflation, rising financing costs and the potential for slowing economic growth. However, deal value showed an uptick by 17% to €167.1bn during the same period, which is impressive considering 2021 was the peak of the 12-year-long bull market characterised by low interest rates, low inflation, high valuations, and a bonanza of IPOs.

Blackstone and the Benetton family's investment vehicle, Edizione, made the largest deal of the year by far with the take-private of Atlantia valued at €42.7bn. The Italian infrastructure group primarily operates in the fields of motorway and airport management, managing several assets across Europe, including Rome and Nice airports, and the Italian highway network, Autostrade per l'Italia. It was previously listed on the Milan Stock Exchange before its successful delisting following a squeeze-out after 90% of shareholders backed the deal.
Blackstone was also responsible for the second-biggest deal when it recapitalised Mileway, a logistics real estate company that specialises in last-mile distribution centres across Europe. The company was founded in 2019 by Blackstone when it brought several logistics assets it had acquired together into one company. The recapitalisation deal valued at €21bn saw the business, which has strategic locations close to urban areas and transportation networks, move between two Blackstone funds, a clear sign of the US PE firm's belief in the long-term potential of the company.

The year 2022 has been the year of smaller deals, owing to the decline in investor confidence caused by Russia-Ukraine war-led economic uncertainty. The count of mega deals (>€1bn) dropped by 31% to 31 deals in 2022, from 45 deals in 2021. The count of large deals’ (€501m-€1bn) registered a steep fall by 62% during the same period. 2022 was the weakest year for large deals during 2017-2022 period, in terms of deal count, as GPs have been more cautious in deploying their capital in a year full of economic and political uncertainty.

Industrial manufacturing including infrastructure have been the prime targets of PE buyout activity recently. These businesses offer compelling insular hedges against inflation. Demand for infrastructure and logistics services is highly resilient and these companies often benefit from long-term inflation-linked contracts, making them dependable investments.

Fig. 2 European Buyout Trends 2017–2022

Source: Mergermarket
Exit trends

The groundswell in PE exits that started in mid-2020 after the immediate impact of the pandemic—and the ensuing monetary and fiscal stimulus response by central banks and governments—reached a crescendo by Q3 2021 and deal volumes began to descend further in 2022. With public market valuations beginning to fall and inflation headwinds gathering, financial sponsors focused on supporting their portfolio companies and looking for potential deal opportunities. Through 2022, there were 699 exits, down 37% YoY, while exit value dropped by 54% to €94.3bn.

One of the largest exits involved co-investors PAI Partners and British Columbia Investment Management Corporation’s sale of Dutch soft drink bottler, Refresco, to KKR in a deal worth €7.1bn in February 2022. PE firms are increasingly factoring ESG into their investment decisions and Refresco fits these criteria, the company’s sustainability progress positions it to benefit from the EU's forthcoming single-use plastics directive, which comes into force in October 2023.

Reflecting the tougher exit environment, the year’s biggest exits were concentrated in the Q1 2022, before the conflict in Ukraine dampened the risk appetite among potential buyers. For example, a PE consortium comprising Ardian, TDR Capital, GIC and Goldman Sachs Merchant Banking Division offloaded LeasePlan, a Dutch global fleet management company that provides a range of leasing and financing services for cars and light commercial vehicles, in January 2022, in a deal valued at €4.9bn. In the same month, January 2022, Bridgepoint divested its majority position in Element Materials Technology Group, to Singaporean sovereign wealth fund, Temasek, in a deal valued at €6.2bn. The UK company is involved in testing, inspection, and certification services for technology and life sciences clients, generating annual revenues of approximately $1bn and experiencing over 20% annual growth in the past decade. Element recently achieved the best ESG rating of any major testing, inspection and certification company globally.

By Q4 2022, quarterly exit volume had fallen to 104, its lowest point during 2017-2022. The primary reason for this low exit appetite is the unfavorable market conditions, set out by the shift in geopolitical and economic policies. The industry is
convinced this marks a bottom for exit activity, and it is expected to heavily regain speed as soon as the financing market opens up again – latest in Q3 2023.

Geography of European deals

The UK & Ireland could not maintain their position as the largest buyout market in Europe in 2021-2022 and slipped to second. However, during this period, these markets maintained their volume at 21% similar to 2019 and 2020. The share of value fell by almost seven percentage points in the same period to 24%. Brexit has brought a lot of disruption and contributed to inflation by increasing trade frictions. Official figures show that the UK’s GDP was still 0.8% below its pre-pandemic level in Q4 2022, while the Eurozone’s economy was 2.4% higher at this time.

At the same time, some of the UK’s challenges have made it an attractive investment destination for foreign funds. Since the Brexit vote, investors have been moving their money out of UK equity income funds, making the UK stock market relatively cheap compared with the US and Europe. The rally in the dollar through 2021 and much of 2022 has also led to interest among US PE funds for UK deals.

France became the largest European buyout market, in terms of volume, in 2021-2022 with 542 deals valued at €51bn. France accounted for 23% and 17% of deal volume and value, respectively, in 2021-2022. In terms of deal value, Italy and Benelux held maximum share of 19% each, owing to the top 2 deals of the year – Atlantia (Italy) and Mileway (Netherlands), which together accounted for a nearly €64bn of deal value.

Germany and Nordics both represented 13% each, in terms of deal volume. However, when measured by value, Germany and Nordics held a share of 7% and 5%, respectively.
While it's true that Germany had a challenging 2022 in the face of soaring energy costs in the wake of the invasion of Ukraine, Blackstone's giant take-private of Atlantia had a massive positive skewing effect for Italy. It is unlikely that the country will maintain its higher position for long and Germany has every chance of regaining its long-held position.

**Fig. 5  European Buyout Volume, Split by Regions 2021–2022**

![European Buyout Volume Chart](source)

Source: Mergermarket

**Fig. 6  European Buyout Value, Split by Regions 2021–2022**

![European Buyout Value Chart](source)

Source: Mergermarket

**Industry focus**

There has been relatively little change in the sector composition of European buyouts recently. Industrial Manufacturing has kept its position as the highest volume and highest value industry by a comfortable margin. There were 847 such deals in 2021-2022, worth a combined €106.2bn, representing 36% and 34% of volume and value, respectively.

Technology, Media and Telecommunications (TMT) sector maintained its second position in 2021-2022, in terms of deal volume. Technology investments in particular ran hot in the second half of 2020 and through 2021, as high-beta assets such as
pre-profit growth stocks and cryptocurrencies surged in the low-yield environment. Digitalisation was the big theme of this period and investors, including PE funds, were eager to capitalise on the opportunity. This came to a halt towards the end of 2021 when investors began to rotate into more defensive sectors such as Consumer Markets, EUR (Energy, Utilities and Resources) and Health Industries, and as it became evident that inflation was more deeply embedded than first expected.

Health Industries deals have been a firm fixture in deal activity in the past two years. The sector's share of deal volume remained at 8.9% and 8.5% between 2019-2020 and 2021-2022, respectively, firmly keeping its position at the third number. Deal value, meanwhile, increased from 8.6% to 11.5% during the same period.

While Big Pharma capitalised on the pandemic, the health crisis also focused fund attention on the sector as they invested in suppliers like diagnostics companies and contract development and manufacturing organisations (CDMOs). The receding threat of COVID-19 has been replaced by the prospect of weaker economic growth and has kept these deals on the priority list. An analysis found that healthcare deals completed in the wake of the global financial crisis had higher median returns than those completed beforehand, with top-quartile internal rates of return reaching 40% or more and outperforming other sectors¹.

Fig. 7 European Buyout Volume, Split by Sector 2021–2022

Source: Mergermarket

Deep dive: DACH spotlight

The DACH region (Germany, Austria and Switzerland) has been impacted harder than most by the recent downturn in PE activity, which is perhaps unsurprising given Germany's previous reliance on Russian gas supplies and the pinching effect on demand due to skyrocketing energy prices as well as the uncertainty that this brought about. PE volume was down by 35% year-on-year (YoY) to 438 transactions in 2022. Deal values took a steeper fall of 45% YoY to €20.5bn in 2022.

Both new deals and exits have been affected to different extents. There were 143 buyouts in the region in 2022, a 38% decline. In Q2 2022, deal values declined by just 8% year-on-year (YoY) to €4.5bn, however, deal values went up by 19% YoY to €7.0bn in Q4 2022.

This mirrors the same trend across Europe and indeed the rest of the world, where activity has been focused on smaller deals that benefit from bilateral borrowing arrangements with relationship banks or with direct lenders, as opposed to large-cap buyouts that depend on syndicated loan markets being open.

One of the top-10 buyouts in Europe in 2022 featured a DACH target. The largest buyout was in the Technology, Media and Telecommunications sector – Global Infrastructure Management and KKR announced to acquire a 32% stake in a joint venture, holding Vodafone’s 81.7% stake in Vantage Towers from Vodafone Group Plc. for a consideration of €3.2bn. The second largest buyout was in the healthcare sector and saw Astorg Partners meet an enterprise value of €2.5bn for Corden Pharma International, a German CDMO that provides a range of services to pharmaceutical and biotechnology companies.

Mid and lower mid-market firms had a surprisingly active year for exits in 2022 in the DACH region. There was a large disparity between the fall in divestment volume and value, the former falling by 38% to 99 exits, while value collapsed by 91% to €3.7bn. Coinciding with Vodafone’s Vantage stake sale, RRJ Capital and DigitalBridge Group helped KKR and GIC to up their exposure via the sale of an 18.2% equity interest in the towerco for less than €3bn. Nevertheless, large transactions were pulled and exits were delayed as uncertainty led to
Fig. 9  DACH Private Equity Trends, 2017– 2022

Fig. 10  DACH Private Buyout Trends, 2017–2022

2 The data for Q1 and Q2 2022 and Q3 and Q4 2022 has been clubbed due to low deal volume and several undisclosed deal values particularly for Q1 and Q3 2022
Deep dive: Benelux spotlight

The Netherlands had a standout year in 2022, making the Benelux region (Belgium, the Netherlands, and Luxembourg) one of the most dynamic PE markets in Europe. This was supported by some of the largest deals recorded last year, including Mileway and Refresco.

Total PE volume only fell by 14% YoY in Benelux to 252 transactions, but the deal value increased by 29% YoY in 2022 to €37bn, outperforming in Europe. High increase in deal value can be attributed to Mileway’s deal worth €21bn. Similarly, buyout volume was down by 21% to 103 transactions totaling €35bn, up by 52% YoY.
Exit volume declined by 33%, while the total value of divestments increased by 10% to €14.3bn.

In addition to the two Dutch deals – which feature in Europe's top-10 deals for the year, Advent International's €3.7bn purchase of Royal DSM's Engineering Materials business in partnership with German chemicals group, Lanxess also featured in the Top 10 mega deals. The target was placed into a joint venture owned by the co-investors to produce high-performance polymers.

The Netherlands, the largest PE market in the Benelux region, finds itself in a relatively strong position. The country had an inflation rate of 7.6% in January 2023, versus the Eurozone average of 8.6%. Global and pan-European PE players in the large-cap and upper mid-market brackets are continually active in the market and domestic players have strong reputations. Case in point: the 2022 HEC-Dow Jones Private Equity Performance Ranking for Large Cap Buyout Firms, which tracks firms from around the globe, ranked the Bussum-headquartered Waterland Private Equity Investments in fourth place. Liquid PE markets, a highly strategic location, an attractive tax system and educated workforce makes the country a jewel in Europe's crown that keeps on going.

**Fig. 13**  Benelux Private Equity Trends, 2017–2022

**Fig. 14**  Benelux Buyout Trends, 2017–2022
Fig. 15  Benelux Exit Trends, 2017–2022

Source: Mergermarket
C. Key Findings
Making the most of new opportunities

GPs continue to screen deal flow—more than half of respondents increased the number of potential transactions they reviewed in 2022 compared with 2021. Further, 58% increased the number of new investments they made in 2022 versus 2021, making the most of a disrupted market.

Funds go head-to-head for deals

This is more than enough dry powder to keep competition for deals running high, so it’s not surprising that 71% of respondents agree that competition for investments among PE firms increased in 2022 versus 2021—30% even going as far as to say that competition increased significantly.

Good news for year ahead?

Most of the optimists believe the PE market in Europe will get only slightly better in 2023, while 33% expect no change at all. At the same time just 23% expect things to get worse. Overall, buyers will be looking for a reality check among vendors over valuations, price gaps having been an obstacle in 2022 amid weaker stock market performance.

Technology no longer tops the pile

As PE rotates out of tech, the consumer sector reaps the benefits, climbing the investment agenda for firms, followed by business services (37%), information technology/software (37%) and industrial production/manufacturing (34%).
**PE firms must manage expectations**

This is in stark contrast to last year, when only 15% reported lower than expected returns, and 34% said they were above expectations. The distorting impact of fiscal and central bank stimulus on markets and their return to earth in the past three years is likely to have played a large role here.

**Data holds huge value for PE**

The application of analytics allows for insights that were never previously possible, including uncovering new deal opportunities—76% of GPs also say they expect to use data analytics to identify potential targets in 2023.

**ESG is here to stay**

This is up from 77% who said the same in 2021. In addition, 64% of firms say they have ESG-specific KPIs for all their portfolio companies and regularly monitor these, up from 17% of respondents who said this in 2021. The Rubicon has been crossed.

**ESG goes hand in hand with performance**

There is a growing recognition of the importance of ESG factors in the long-term financial performance of investments. It’s becoming clear that investing with an environmental and social conscience can deliver financial returns.
D. Detailed Findings
Part 1: 2022 in review

PE markets pause for breath

Last year, following 12 months of record-breaking performance, PE activity in Europe settled down to more realistic levels, in line with a slowdown across the broader global market.

Of course, it did not come to a standstill—the region still slightly outperformed the global average. There were 3,113 PE deals (inc. buyouts and exits) in Europe worth a total of €358 bn, respective drops of 13.4% and 29.9%. On the international stage, PE volume dipped by 15.7% and value by 31.5% to 8,874 deals valued at €1.28 trn in total. This remains above pre-pandemic levels and is more of a return to regular activity rather than a cause for concern.

A majority of PE funds were more active evaluating deal flow last year than in 2021. Over half (59%) of respondents increased the number of potential transactions they reviewed in 2022 versus 2021. A similar percentage (58%) say their organisation increased the number of new investments they made in 2022 compared with 2021, making the most of a disrupted market. Further, 18% significantly upped their activity—by comparison, in 2021, 23% of funds said they leaned heavily into new acquisitions.

Interestingly, 59% of respondents say that the conflict in Ukraine supported an increase in the number of investments made by their organisation in 2022. The war has had numerous impacts in Europe, from exacerbating inflation to a broad re-engineering of gas supply lines. It also confirmed what was likely the beginning of a turning point for PE markets following a post-pandemic value surge. As company valuations fell in 2022, funds sought to capitalise on the opportunity.

Fig. 16 Compared to 2021, has the number of potential transactions which you have reviewed in an average month this year increased or decreased?
Heightened competition

PE funds reported record inflows from investors in 2021, as fundraising surged through the year but, in 2022, the train lost momentum. All the same, dry powder remained high due in part to PE deal values dropping. By mid-December 2022, according to S&P Global, there was still $1.96 trn of committed but uninvested capital available to fund managers globally. This is more than enough to keep competition for deals running high, especially for high-quality assets in the mid-market buyout space, where the availability of financing has been less impacted.

Against this wall of capital, 71% of respondents agree that competition for investments among PE firms increased in 2022 compared with the year before—30% even going as far as to say that competition increased significantly.

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Opinion is divided on exits

It was a tough period for exits last year. In Western Europe, according to data from Mergermarket, portfolio company sales were down by 25% to 954 and values plummeted by as much as 39% to €150.7 bn. The second half of the year was particularly brutal as confidence began to wane, with 37% and 60% declines in deal volumes and values, respectively, year-on-year.

One reason for deal values sinking harder than volumes was the challenging state of debt financing markets for larger assets. As a result, large-cap sponsor-to-sponsor activity was down, combined with the fact that IPOs were all but off the table and lower equity prices disincentivised corporates from issuing new stock to fund acquisitions.

This meant the core middle-market showed more buoyancy overall, though all sponsors faced higher financing costs in 2022 and this will have made them highly sensitive to pricing. All of this had an impact on exits, given that secondary buyouts were so ubiquitous in 2022.

Respondents are relatively split as to whether the number of exits made by their firm changed in 2022 compared with 2021—39% say they increased while 33% say they decreased. This is a surprisingly upbeat reading and is testament to the strength of the mid-market.

While war loomed large in 2022 and continues to rage, there appears to be little correlation between the conflict in Ukraine and the number of exits being made. Over a third (36%) say the war led to a decrease in divestments, but a similar proportion (40%) say it supported an increase in exits. Of course, it is not the war itself that has directly affected the market, but its second-order impact on inflation, coupled with rising interest rates influencing an increase in financing costs and the disruption to supply chains affecting business performance.
Fig. 20  Compared to 2021 has the number of exits made by your organisation this year increased or decreased?

Fig. 21  How has the conflict in Ukraine in 2022 impacted the number of exits of your portfolio companies?

Positive performance in trying times

Overall, PE firms are optimistic about how their investments performed during what has been an undeniably testing year. Half of respondents say they are satisfied with the development of their portfolio companies in 2022, versus 24% saying that they are dissatisfied.

This speaks to the fact that the greatest impact of the macro environment in 2022 has been on dealmaking rather than on business performance of existing investments.

As for the downstream impact of the Ukraine conflict, 47% of respondents point to increased difficulty in securing financing and 42% cite significantly increased financing costs as the biggest negative impacts they have experienced. In general, the war in Ukraine seems to be affecting the ability to buy and sell companies rather than hampering existing portfolio company performance.

Of course, existing holdings are not immune to the effects of rising debt servicing costs and supply chain bottlenecks are another cause for concern. Over a third (36%) of respondents flag these disruptions, including the partner of a Norwegian PE firm who says: “The supply chain challenges that already existed due to the pandemic increased significantly and it has become tough to implement the usual strategies. We were not expecting these disruptions to continue for this long.”
While the relationship between GPs and limited partners (LPs) is also evolving, the pandemic accelerated the rules of engagement. Communication and transparency increased as both sides were forced into video conferencing to keep dialogue open. Technology that had already grown in importance before the pandemic took centre stage in reporting.

LPs also became increasingly hands-on, seeking greater involvement in the investment decision-making process and demanding more information on the performance of their investments. In addition, there is a growing trend towards longer-term partnerships between GPs and LPs, with LPs committing to investments for extended periods and GPs prioritising alignment of interests with their LPs.

The survey findings confirm these trends: 43% of respondents say their expectations and requirements of their LPs increased in the past three years, during the
pandemic. At the same time, just over half (51%) say their expectations and requirements remained the same, reflecting the fact that investors have been demanding more of their PE managers for several years. Raised expectations are now very much the status quo.

Of those that say they expected more of their LPs in recent years, a large majority say the main change they expected involved either ESG (50%) or increased disclosure requirements (36%)—no surprise, since these two go hand in hand.

There is a growing recognition among LPs of the importance of ESG in the long-term financial performance of investments. Institutional investors like pension funds have fiduciary duties to their clients and have to be transparent when reporting ESG matters, which carries through the chain. As this reporting becomes more sophisticated, larger investors will be better able to compare and contrast the ESG performance of their portfolio across various asset classes from both a granular and high-level perspective using sophisticated data analytics tools.

Governments and regulators are also playing a role by imposing requirements for ESG reporting and disclosure, putting pressure on fund managers to provide more information to LPs. Specifically, the Sustainable Finance Disclosure Regulation (SFDR), introduced in March 2021, forms part of the EU’s wider efforts to promote sustainable finance and drive investments towards activities that support sustainable economic, social and environmental outcomes.

The regulation requires financial market participants, including PE firms, to disclose how sustainability risks and opportunities are considered in their investments, as well as the ESG policies and practices of their funds. GPs must also categorise their products based on their sustainability characteristics and provide additional information to investors based on the sustainability profile of the funds, so LPs can establish like-for-like comparisons when making capital allocation decisions.

**Fig. 24 Have expectations and requirements of your limited partners (LPs) changed during the prior three years?**
Fig. 25  If your expectations and requirements of your limited partners (LPs) have increased during the prior three years, which of the following best describe the changes in expectations and requirements? (Please rank top three, where 1 = biggest change)

<table>
<thead>
<tr>
<th>Change Description</th>
<th>Rank 1</th>
<th>Rank 2</th>
<th>Rank 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased expectations on ESG topics</td>
<td>50%</td>
<td>28%</td>
<td>7%</td>
</tr>
<tr>
<td>Increased disclosure requirements</td>
<td>36%</td>
<td>29%</td>
<td>16%</td>
</tr>
<tr>
<td>Pressure on management fee levels</td>
<td>1%</td>
<td>11%</td>
<td>31%</td>
</tr>
<tr>
<td>Increased frequency of individual co-investment</td>
<td>5%</td>
<td>9%</td>
<td>31%</td>
</tr>
<tr>
<td>Increased value of individual co-investment</td>
<td>5%</td>
<td>23%</td>
<td>15%</td>
</tr>
</tbody>
</table>

- **RANK 1**
- **RANK 2**
- **RANK 3**
Part 2: The year ahead

A mixed picture in 2023

This year brings very different challenges for PE firms looking at potential investments. On the one hand, debt is now more expensive and there are various macro challenges, including slowing growth and decades-high inflation.

On the other hand, the outlook in Europe is brightening. In January 2023, the S&P Global Eurozone Manufacturing PMI came to 48.8, up from 47.8 the previous month and the weakest rate of contraction in the sector since August 2022.

Data for December 2022 shows that factory orders in Germany were up 3.2%, a reversal of the 4.4% contraction a month prior. There was also a pronounced rally in the Eurostoxx 50 index in the four months from September.

It is too premature to call this an inflection point for the macro environment in Europe, but these are promising signs. Add to that, the wall of dry powder that PE firms have at the ready and the fact that the middle-market has been holding up well, there is good reason to expect steady deal volumes. Looking to the rest of the year, 57% of respondents expect their firms to increase the number of new investments they make, with just 7% expecting the number to decrease.

GPs are also net positive about the outlook for exits—51% anticipate the number of divestments they make in 2023 to stay the same as the previous year while 34% say it will increase slightly. PE funds will be treading carefully in 2023 following a rocky year, but there is a sense that most expect the year ahead to be stable after such a challenging period. However, respondents are not taking an extreme view either way; none expect a significant decrease and only 2% see a major increase in divestments.

Fig. 26  Compared to 2022, do you expect the number of new investments made by your organisation in 2023 to increase or decrease?
Macroeconomics are a factor

Respondents have a similar view of the health of the PE market. Few firms see significant improvement or deterioration on the horizon for 2023. Overall, 44% see it improving while 33% expect things to remain broadly the same.

Economic forecasts for Europe this year vary, falling somewhere between a mild recession and meagre growth. The International Monetary Fund’s latest projection has euro area growth at 0.7% for 2023, while the UK could drop to -0.6%.

These are subject to change, and some see China’s emergence from COVID-19 lockdown conditions early this year as a potential boost for export markets like Germany and Italy. After the post-lockdown boom and with the European Central Bank (ECB) now cautiously pressing the brakes, it is hard to see how GDP will perform exceptionally well this year and PE fund managers are all too aware of this reality. More than half (54%) of respondents expect low global growth in 2023 and 29% predict the year will be flat. Positively, only 14% believe there will be a recession.

The conflict in Ukraine sent inflation even higher in 2022. There have been hopeful signs since October 2022, with the Harmonised Index of Consumer Prices in Europe falling from 10.6% in that month to 8.5% in January 2023. This is still high and is having an impact on financing as the ECB raises interest rates for the Eurozone. Looking to 2023, respondents expect the strongest impacts of securing financing and 47% to significantly increased financing costs. These are conditions that the industry has not experienced for some time and will be new for many managers with less experience.

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Fig. 28  How do you expect the European deal market for private equity to develop in 2023? Do you think it will get better or worse?

<table>
<thead>
<tr>
<th>Expectation</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Get significantly better</td>
<td>41%</td>
</tr>
<tr>
<td>Get slightly better</td>
<td>33%</td>
</tr>
<tr>
<td>Stay broadly the same</td>
<td>20%</td>
</tr>
<tr>
<td>Get slightly worse</td>
<td>3%</td>
</tr>
<tr>
<td>Get significantly worse</td>
<td>3%</td>
</tr>
</tbody>
</table>

Fig. 29  How do you expect the world economic situation to develop in 2023?

<table>
<thead>
<tr>
<th>Economic Growth</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>High growth</td>
<td>3%</td>
</tr>
<tr>
<td>Low growth</td>
<td>54%</td>
</tr>
<tr>
<td>No growth</td>
<td>29%</td>
</tr>
<tr>
<td>Contract slightly</td>
<td>14%</td>
</tr>
<tr>
<td>Contract extensively</td>
<td>0%</td>
</tr>
</tbody>
</table>

Fig. 30  Looking forward to 2023 and the effects of the conflict on Ukraine, which of the following do you expect will have the strongest impact on your firm as well as your portfolio? (Please select top two)

<table>
<thead>
<tr>
<th>Impact</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased difficulty in securing financing</td>
<td>50%</td>
</tr>
<tr>
<td>Significantly increased financing costs</td>
<td>47%</td>
</tr>
<tr>
<td>Increased difficulty in buying and/or selling portfolio companies</td>
<td>40%</td>
</tr>
<tr>
<td>Disruption of established business models</td>
<td>30%</td>
</tr>
<tr>
<td>Supply chain challenges</td>
<td>26%</td>
</tr>
<tr>
<td>Exposure to Russia has been significantly reduced</td>
<td>7%</td>
</tr>
</tbody>
</table>
What’s driving deals in 2023?

Buy-and-build is expected to be popular this year. While public markets softened in 2022, private market valuations have been slower to adjust. Anecdotally, some LPs speak of their GPs not writing down the net asset values of portfolios and this makes platform deals expensive at a time when there are difficulties in securing the required financing. With add-ons, PE funds can typically tap the lending arrangements they already have with a platform they own to finance the deal and can take advantage of corporates looking to dispose of non-core assets.

As much as 90% of our respondents say that buy-and-builds will be one of the most important factors influencing equity stories on their acquisitions in 2023, with 33% saying this will be the main factor. The next most cited factor is operational improvement (71%), followed by financial engineering (63%). A 55% majority also point to supply chain resilience, a top priority for the foreseeable future.

Fig. 31 Looking forward to 2023, which of these factors do you consider will influence equity stories on acquisitions for your organisation? (Please select all that apply and the main factor)

Large proportions of respondents expect new deal opportunities for their organisation in 2023 to come from growth capital (92%), ahead of direct investments (83%), acquisitions of majority shareholdings from private owners (80%), acquisitions of mid-cap family businesses (78%) and acquisitions of assets out of insolvency/distress (72%).

One of the key distinctions of expansion deals, apart from their core focus on growth, is that they do not rely on leverage for returns. They also typically involve minority stakes—funds with the right expertise to manage these investments can minimise their exposure to individual deals while also circumventing the need for financing.

While technology was the preferred choice in 2021, the consumer sector tops the list for potential GP investment in the next two to three years. Two-fifths of sponsors expect to deploy capital in this industry, although opinions on this are relatively balanced. More than a third (37%) anticipate investments in both business services
and information technology, while 34% expect manufacturing deals. Sponsors are keeping an open mind about where to access deal flow to keep their options as open as possible.

Fig. 32 In your opinion, which, if any, of these will be sources of new deal opportunities for your organisation in 2023?

![Graph showing the distribution of deal sources with Expansion/Growth Capital at 92%, Direct Investments at 83%, Acquisitions of majority shareholdings from private... at 80%, and other sources at lower percentages.]

Fig. 33 In your opinion, which of the following industries is your organisation most likely to invest in over the next 2 to 3 years? Please name a maximum of 3 industries. (Please choose up to three) – Top answers shown

![Graph showing the distribution of industries with Consumer at 40%, Business Services at 37%, Information Technology/Software at 37%, and other industries at lower percentages.]

Relatively low risk of default

PE firms have not seen a higher-rate environment for well over a decade, as central banks kept borrowing costs low to stimulate growth following the global financial crisis. As a result, concerns are growing that we could be heading into loan default territory in 2023.

However, fund managers work proactively with banks to avoid such a situation, establishing regular communication with banks and other lenders to keep them...
abreast of the financial performance of their portfolio companies, identifying any potential issues early on and finding solutions before they become bigger problems.

PE firms may also negotiate with their lenders to loosen loan covenants, such as raising interest coverage or leverage ratios, giving portfolio companies more headroom. Restructuring may be required in some cases, such as extending the maturity of loans, reducing the interest rate paid or converting debt into equity.

Based on our survey, it appears that PE firms are ahead of the curve. Our results suggest a decreasing proportion of portfolio companies will be breaking one or more bank covenants, or otherwise needing to enter negotiations with their financing providers in 2023. As much as 86% of respondents said that covenant breaches or negotiations applied to more than 10% of their portfolio companies in 2021, falling to 56% in 2022 and only 35% who expect this in 2023.

**Fig. 34** What percentage of your portfolio companies broke one or more bank covenants, or otherwise need to enter negotiations with their financing providers in 2022 and how many do you expect will break one or more in 2023?

![Chart showing percentage of portfolio companies breaking bank covenants](chart)

* 2021’s survey result represents a different pool of respondents

PE returns shot up in 2021 as valuations soared. Pitchbook data show that, globally, PE registered a 45.8% internal rate of return (IRR) in the year through Q4 2021, before falling to 29.9% in Q1 2022. By mid-2022, returns were in negative territory in what has been a rollercoaster ride.

Sentiment has soured somewhat among our respondents, likely owing to this downward trend. Just over half (55%) say that their returns on investments made in the past five to seven years are now likely to be lower than previously anticipated. This is in stark contrast to last year, when only 15% reported lower than expected returns, and the rest reported returns to be either as expected (51%) or above expectations (34%). Just 6% of respondents in our latest survey feel that returns were higher than expected in 2022.

One might expect GPs to be more positive about the outlook for deals they made last year, but that is not the case. Respondents are most commonly less than optimistic about expected returns on investments made in the past year compared to the returns on investments made five to seven years ago, with 62% expecting them to be lower.

Typically, weaker periods for public equities are a proxy for stronger PE vintages, as funds can acquire companies more cheaply and sell them for greater multiples on invested capital. However, there appears to have been a lag in private market

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valuations in 2022 and deals made last year, particularly in the first half, could represent entries at or near the market top. That could weigh on returns on acquisitions made in 2022. That is far from guaranteed and will depend on how the economy and general business performance shapes up over the coming 12–24 months.

**Fig. 35** Looking back on the returns on investments you made during the past five to seven years have they been / are they expected to be higher or lower than expected?

![Bar chart showing returns on investments](image)

* 2021’s survey result represents a different pool of respondents

**Fig. 36** Looking forward towards the expected returns on investments made during the past year, how do these compare to the returns on investments made five to seven years ago?

![Bar chart showing expected returns](image)

**Critical concerns for PE in 2023**

Declining portfolio valuations are clearly a concern, with 53% of respondents citing this as one of the critical issues that the PE industry in Europe will contend with in the next five years, and most likely in the very near term. It is entirely possible, if not likely, that valuations five years from now will in many cases be well above where they are today.

However, it is increasing regulation that is the top-cited issue, with 57% of respondents highlighting this as a challenge. On watchlists among larger sponsors is the upcoming Foreign Subsidies Regulation (FSR), which is set to bring new approval requirements for a significant number of M&A deals, particularly those involving PE firms and other financial investors. The notification obligations are
expected to take effect by Q3 2023, following the entry into force of the FSR, which is slated for mid-2023.

The FSR was created to address what the European Commission (EC) believes is a regulatory gap, where subsidies granted by EU member states to EU companies are closely scrutinised under state aid rules, while subsidies from non-EU countries pass under the radar.

This new regulation will give the EC the power to identify foreign subsidies received by EU companies, determine if these affect the internal market and, if necessary, impose remedies to restore fair competition.

While further guidance is expected for clarity, the FSR potentially covers any deal made by a PE firm in a company with revenues above €500 m from an equity fund that has more than €50 m from any one non-EU state-backed pension fund. This comes on the heels of PE having only recently adjusted to the SFDR. Suffice to say, the regulatory picture in Europe is only becoming more complex.

Fig. 37 Again looking ahead, what are the key issues which the private equity industry in Europe will face in the next 5 years? (Please rank top three, where 1= most important issue)
Part 3: Operational improvements, value creation and digitisation

Creating value via operational improvements

Operational improvements still reign supreme as the greatest lever for enhancing returns on investment (ROI) in PE. This hands-on, active ownership model is what sets PE apart from other asset classes such as passive investing in publicly traded stocks. Bringing expertise, resources and networks to the table to drive growth and create value in portfolio companies is the industry’s key differentiator.

According to 73% of respondents, this levelling up of businesses is one of the two top influences on returns and 32% cite it as the key driver. These improvements cover a wide range of activities, from streamlining operations and cutting costs to developing new products and expanding into new markets. PE funds have strong pedigree in this area, and this is where true alpha can be generated.

Financial leverage of course plays a role in amplifying ROI, if used judiciously. Just over half (52%) of GPs see debt as one of the two biggest ingredients to boosting returns, with 32% seeing it as the top influence. Leverage allows funds to control a larger portion of a target company with a smaller amount of equity and can maximise returns by boosting capital gains.

However, this comes with the risk of loss if the target company does not perform as expected. With debt financing now more expensive, leverage should play a smaller role and more will rest on asset valuations. GPs need lower entry prices to make higher debt costs balance out as they will generally need to use more of their own equity capital in deals.

Looking forward, 70% of respondents expect to see an increase in the impact of operational improvements—especially digitisation (82%)—on their ROI. Only 48% expect to see such an increase for financial leverage.

This signals a departure from the previous three years, over which 61% of PE firms say leverage had an impact on their returns, at a time when financing was cheap. In today’s higher-rate and more credit-constrained environment, sponsors will have to rely less on debt and more heavily on what sets these active shareholders apart. Notably, digitisation was seen by 64% as having the biggest impact on ROI in the recent past and is now considered the biggest driver of all. This is a marked turnaround.

GPs can automate manual processes to help portfolio companies become leaner and reduce costs, use software to drive sales growth and data analytics to inform decision-making, optimise pricing strategies and identify new market opportunities. Above all, PE firms must work to develop and embed a culture within their portfolio companies that values and embraces digital innovation and adoption. This is the next phase of PE’s tried-and-tested approach to bolster operations.
Fig. 38  Please rank the following in terms of importance, regarding their influence on your return on investment. (Please rank 1 to 4, where 1 is the most important and 4 is the least important) – Rank 1 and 2 shown only

![Bar chart showing rankings of operational improvements (excluding digitization), financial leverage, digitization, and multiple arbitrage.]

Fig. 39  During the past three years, has the impact of operational improvements (excluding digitization), multiple arbitrage, financial leverage and digitisation on your return on investment increased, decreased or stayed the same?

![Bar chart showing changes over the past three years for operational improvements (excluding digitization), digitisation, financial leverage, and multiple arbitrage.]

Fig. 40  Looking forward, do you expect the impact of operational improvements (excluding digitization), multiple arbitrage, financial leverage and digitisation on your return on investment to increase, decrease or stay the same?

![Bar chart showing future expectations for operational improvements (excluding digitization), digitisation, financial leverage, and multiple arbitrage.]

Private Equity Trend Report 2023 – Europe | 42
Pull the right levers for value creation

Before PE firms invest, they need to develop a clear and compelling equity story that lays out the investment thesis and value proposition of a deal. This will outline the firm’s expectations for growth, as well as market trends and opportunities it has identified, and the value-additive strategies that it plans to implement to increase the target company’s value.

What exactly that narrative is will depend on the deal target in question. There are various levers to pull. According to almost three-quarters of respondents, levers of the greatest importance for value creation within the equity story include digitisation (37%) and operational cost reduction (36%).

Ranking as the third-most important lever overall is crisis management, including supply chain and cyber risks. Cyber considerations have been top of mind for some time already as the frequency and severity of cybercrime have continued to escalate over the past two decades. Prior to the pandemic, however, supply chains were less scrutinised than they are today.

A bull-whip effect started in 2020, with suppliers running down their capacity only to be understocked when demand rebounded sharply. This caused serious snarls and led to inflation running hot. The war in Ukraine and widespread nearshoring and onshoring of supplier arrangements have further disrupted the situation. PE funds are now having to think more carefully about how this can impact their investments and adapting as the ground shifts beneath their feet.

According to 74% of respondents, the importance of value creation levers has changed the way they look at new investments, and they model these into their equity story either during due diligence or at entry. Over a quarter (26%) say the importance of these levers has changed their perspective on value creation to a great extent.

“Value creation levers have changed how we perceive risks in new investments. In cases where operational costs cannot be optimised any further, that will mean you are looking at stagnant or decreasing profit margins with inflation so high,” says the investment director of a French PE firm.

In principle, the use of financial leverage is a form of value creation in that it can improve returns for LPs. However, it does not create value in portfolio companies themselves and does not represent genuine alpha. If the ECB continues with its tighter interest rate policy and growth remains pinched, leverage should play a smaller role in the near term and sponsors will depend more on their operational toolkit. Respondents expect the importance of this true value creation to increase either moderately (35%) or strongly (31%) in the future.
Fig. 41 Which levers are most important to value creation within the equity / investment story? (Please rate each on a scale from 1 to 10: 1 being “least important” and 10 being “most important”)

Fig. 42 Has the importance of value creation levers changed the way you look at new investments and do you model it into your equity story already at entry / during the due diligence phase?

Fig. 43 How do you expect the importance of value creation to develop in the future?
The ongoing impact of digital

Data collection and analysis combined with more advanced applications such as artificial intelligence (AI) can offer PE firms a clearer view of the risks that may lie ahead. This is where sponsors are seeing the biggest results overall.

Asked about the impact of digital transformation on various elements of their firms’ business models, risk management comes out on top among respondents. By digitising data collection processes, PE firms can quickly and accurately gather information on portfolio companies, allowing them to identify potential risks and make informed decisions. This can also enable real-time monitoring, in which firms can track portfolio company performance, providing early warning signs of potential risks and enabling prompt intervention.

The impact of digitisation can also be seen in areas such as marketing, sales and customer service, as well as supply chains and logistics. All of this is value accretive; by building more resilient and higher-performing businesses, funds are more likely to achieve successful exits when they come to sell their investments—delivering greater cash distributions to their LPs. A vast majority of respondents believe that the level of digital transformation is either important (62%) or very important (32%) to future exits from their current portfolio companies and subsequent returns.

Fig. 44 How would you rate the level of impact from digital transformation on the following elements of your company business model? (Rate from 1 to 10, 1 impacted least, 10 impacted most)
PE continues to embrace digital transformation as a means of driving value. More than two-thirds (69%) of respondents say they invested in transforming their own firm or the business models of their portfolio companies in the past year.

However, this is a significant step down since our survey published in 2022, when 94% said the same. This reflects the more challenging investment and cost environment in which sponsors now operate. Digitisation can take time to deliver results and, in 2022, there was added pressure for PE funds to deal with shorter-term risks. In this sense, GPs have been forced to manage their priorities.

Among those that say they invested in digital transformation, 72% focused their efforts on data analytics, followed by more than half that directed spend on AI (55%) and Internet of Things (54%) capabilities.

“The availability of data has increased consistently; however, there were few solutions to optimise its use,” says the investment director of a German PE firm. “We invested in analytics so that we could glean more actionable insights for critical decision-making.”

PE firms are using analytics to gain insights into consumer behaviour, market trends and other key metrics that can inform investment strategies and decisions. They are also using the technology across the investment cycle, showing just how broadly these tools can be applied. For example, 89% say that analytics was used to conduct due diligence in 2022, 71% used it in their valuation modelling and 61% for identifying potential companies for investment.

Most striking is the fact that all areas of the investment process are expected to see the increased application of data analytics in 2023. Virtually all (98%) respondents expect to apply analytics tools to due diligence this year, while 81% plan to do so in valuations, and 76% for identifying deal opportunities. In fact, data crunching is expected to increase in 2023 across all areas on which respondents were surveyed, showing a clear direction of travel.

These findings highlight the continued trend towards digitisation in the industry, with 76% of respondents saying they plan to invest in this area in the next year, albeit this implies a slight slowdown in the trend—in our previous survey, 99% of respondents said they expected to invest in digitisation in the following year. This speaks to the more challenging macro environment with which PE firms are now contending.
Given the results data analytics have already delivered, it’s no surprise that this technology remains a priority—78% of respondents expect this to be among the most important areas of focus, while a quarter say it will be the single most important area. In addition, PE firms are planning to invest in AI (59%), cyber security (57%) and the Internet of Things (53%).

Cutting-edge technologies such as AI are being used to automate repetitive and time-consuming tasks such as financial forecasting and risk analysis, freeing up time for more strategic activities. AI and analytics are complementary tools that can be used to analyse large volumes of data and identify potential investment opportunities, reducing the time and effort required for manual research.

“The use of AI and data analytics is vital during dealmaking,” says the principal of a UK PE firm. “The due diligence processes are completed seamlessly when AI is used to review information and complete paperwork evaluations.”

**Fig. 46** Have you made investments in digitally transforming your own firm or portfolio company business models in the past year?

* 2021’s survey result represents a different pool of respondents

**Fig. 47** If so, in which of the following areas of digital transformation have you focused your investment?
**Fig. 48** In which of the following areas of the investment cycle has your organisation used data analytics in 2022?

- **Due diligence**: 46% (89%)
- **Valuation**: 23% (71%)
- **Identification of potential target companies**: 14% (61%)
- **Aggregation of portfolio company KPIs**: 8% (50%)
- **Identification of potential business risks and breaches (e.g. cyber security risks)**: 6% (42%)
- **Predicting portfolio company performance in the future**: 3% (25%)

*All that apply*  
*Most important*

**Fig. 49** In which of the following areas of the investment cycle do you anticipate your organisation will use data analytics in 2023?

- **Due diligence**: 34% (98%)
- **Valuation**: 22% (81%)
- **Identification of potential target companies**: 13% (76%)
- **Aggregation of portfolio company KPIs**: 9% (58%)
- **Identification of potential business risks and breaches (e.g. cyber security risks)**: 13% (51%)
- **Predicting portfolio company performance in the future**: 9% (31%)

*All that apply*  
*Most important*

**Fig. 50** Will you be investing in digitisation over the next year?

- **2022 response**: 24% (76%)
- **2021 response**: 1% (99%)

*Yes*  
*No*

*2021’s survey results represent a different pool of respondents*
If you plan to invest in digitisation over the next year, in which of the following areas will you be investing?

- Data Analytics: 26% (59% most important)
- Artificial Intelligence: 17% (59% most important)
- Cyber security: 23% (57% most important)
- Internet of Things (IoT): 12% (53% most important)
- Robotics: 4% (25% most important)
- Blockchain: 9% (19% most important)
- Augmented Reality: 5% (18% most important)
- Virtual Reality: 2% (15% most important)
- 3D Printing: 2% (5% most important)
- Drones: 0% (2% most important)

All that apply Most important
Part 4: ESG and responsible investing

ESG is now non-negotiable

All PE firms that we surveyed at the end of 2022, without exception, agree that they have a responsible investing/ESG policy as well as the tools to implement it. This is a significant increase on the 77% of firms that said they were in this position in our previous survey.

GPs now know they must align their portfolios with societal and investor expectations by prioritising sustainability and mitigating social harms. This starts with a codified policy that integrates non-financial criteria in investment decision-making. These policies aim to ensure that investments not only generate financial returns, but also have a positive impact on society and the environment.

In practice, PE firms are incorporating ESG principles in their due diligence efforts, engaging with portfolio companies to improve their ESG performance, excluding investments in controversial industries and measuring and reporting against key performance indicators (KPIs).

![Fig. 52](image)

**Fig. 52** Does your firm have a responsible investing or ESG policy and the tools to implement it?

- 100% in 2022 compared to 77% in 2021
- 16% in process of setting one up
- 7% not yet

*2021’s survey results represent a different pool of respondents

ESG is not all about saving the world

More sophisticated PE firms can improve their reputation with investors, mitigate risks and, most importantly, enhance long-term value through the effective application of ESG criteria to their investment strategies.

Companies with embedded ESG practices and corporate strategies that earn them a social licence can grow faster than their peers and demonstrate greater resilience in the face of economic headwinds. With cost-saving initiatives in place supporting energy conservation and waste reduction, there are also efficiency and profitability gains to be had.

One study by researchers at the London Business School recently found that, from 2000 to 2020, the usage of ESG-related words on PE firm websites grew by 200% as they sought to keep up with transparency and higher standards in the PE sphere. What’s more, these disclosures were associated with a 4.9% increase in the net IRR of a fund.6

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Nearly two-thirds (64%) of respondents say that ESG value levers are always a core part of their value creation story when assessing buy-side opportunities—a significant jump from the 26% that said the same in our previous survey—with a further 34% saying they are a core part of their value creation story in most instances. It is not always the case that fund managers target companies with the highest ESG credentials, but they can level these businesses up to become exceptional performers.

“Sometimes we have to be more open-minded in this regard. ESG matters are often prioritised only once the deal is complete, and we take the company on a journey,” says the partner of a Belgian PE firm. “But it’s a core part of the value creation story in most cases.”

Given the potential for enhanced returns, it is little wonder that ESG has come to the fore.

![Chart showing the percentage of respondents who consider ESG value levers a core part of their value creation story when assessing buy-side opportunities. The chart shows a significant increase from 26% in 2021 to 64% in 2022.](image)

*2021’s survey results represent a different pool of respondents

**Meet ESG targets and hit higher returns**

Year-on-year, the proportion of respondents that say they set ESG-specific KPIs for all of their portfolio companies and regularly monitor these has increased significantly, from 17% in our previous survey to 64% in the latest findings.

These indicators play a vital role in enabling GPs to ensure that their portfolio companies are making progress towards agreed goals and help LPs to understand how their capital is invested over time.

The most common of these KPIs include carbon emissions tracking; the monitoring of water consumption; diversity and inclusion among employees and across leadership positions, as well as policies related to inclusion and equal opportunity; labour practices such as employee turnover, benefits offered and working conditions to evaluate a portfolio company’s adherence to responsible standards; and supply chain management KPIs such as supplier diversity and ethical sourcing.

These indicators will become more numerous and specific as the industry matures, but there’s no denying that they can produce results.

Since the previous survey, the proportion of respondents that believe the return on ESG investment exceeds the cost has almost doubled, from 36% to 71%. This is a massive year-on-year gain and indicates that firms are now reaping the rewards of the groundwork that has been laid in recent years.
The decision to prioritise ESG inevitably comes with a trade-off in the short-term, as the costs of implementing new policies and practices can be significant. However, our results demonstrate that this investment pays off over time as GPs pass the bottom of the J-curve (the initial dip in performance associated with sunk costs that comes before a long-term increase). This latter performance can come from improved operational efficiencies, enhanced brand image and a reduced risk of ESG-related challenges such as regulatory fines and reputational damage.

By taking a long-term approach and investing in ESG capabilities at both the PE firm and portfolio company level, firms can harvest the benefits of a more sustainable and responsible investment strategy.

**Good governance is essential**

When it comes to responsible investing, half of respondents (50%) consider governance to be important, well ahead of any other area, with 27% ranking it most important. In a PE context, good governance is seen as a critical factor in ensuring the long-term success of portfolio companies and achieving optimal returns for investors.
PE firms typically seek to improve the governance of their portfolio companies through a range of measures such as enhancing the skills and expertise of the board, improving risk management processes and establishing clear lines of accountability and reporting. This is necessary for achieving ESG goals. Without strong governance, meaningful progress is unlikely to be achieved.

Governance has been a focus of PE since the industry began, long before ESG shot up the corporate agenda. Balancing the often-disparate elements of ESG is a tricky task and some can even negatively offset each other. For example, a renewable energy company may have a high environmental score but inadvertently source their photovoltaic cells from suppliers using forced labour in their production. Determining how to invest capital in an ESG-aligned manner is not always straightforward and prioritising the various pieces of the puzzle is not always practical.

Much of the focus to date across the investment landscape has been on the environmental side of ESG, following government efforts towards improving sustainability and achieving net-zero emissions. Although respondents are mixed regarding which area of ESG is their main focus in their investments and portfolios, the most popular focal point is, unsurprisingly, environmental, selected by 41%. However, the social part of ESG is becoming an increasingly hot topic of public debate and investors are now considering such issues as their environmental policies and practices mature. We therefore expect this to become a greater area of attention in the next five years.

Fig. 56 Please rank the following areas of responsible investing in their importance to you from 1 (most important) to 8 (least important) - Ranks 1 and 2 shown only

- Governance and resources: 27% (Rank 1), 23% (Rank 2)
- Investment decisions and pricing: 16% (Rank 1), 10% (Rank 2)
- Policy and tools: 15% (Rank 1), 13% (Rank 2)
- Monitoring and reporting: 11% (Rank 1), 15% (Rank 2)
- Public reporting: 9% (Rank 1), 11% (Rank 2)
- Engagement with investors: 8% (Rank 1), 11% (Rank 2)
- Valuation of ESG performance: 7% (Rank 1), 9% (Rank 2)
- Integration through deal cycle: 8% (Rank 1), 7% (Rank 2)
Fig. 57  Which one of the following is the main focus of your investments and portfolios?

- Environmental: 41%
- Governance: 35%
- Social: 24%
Part 5: Zooming in on Germany

A sea change in German PE?

The UK and France have long been the interchangeable frontrunners of Europe’s PE market and have far higher PE investment-to-GDP ratios. In the UK, buyout investment accounted for 2.5% of its economy in 2021, according to Statista\(^7\), while in France this was at 1.1%.

In Germany, meanwhile, it was just 0.33%.

However, the country is the undisputed economic leader in Europe. With companies becoming more welcoming of PE and recognising its ability to improve operational performance, catalyse strategic development and spur job creation, Germany’s PE market has become more attractive and sought after by funds seeking to tap the country’s prowess in areas such as high-tech manufacturing.

It is no surprise then that 58% of firms say that they have some exposure to Germany already in their portfolios. Of this group, 93% plan to make further investments in the country in the next five years.

However, the mood has changed in the past 12 months and respondents are less determined to increase their exposure than they were a year ago. Of those that have already invested in Germany and plan to continue to do so, only 42% think that the assets they allocate to the country will increase in the next five years.

This is markedly down from the 80% in our previous survey that said they expected to increase deployment. Instead, GPs are holding their allocation strategies steady for the time being—and none have plans to decrease their exposure.

According to national development bank, KfW’s German Private Equity Barometer\(^8\), sentiment in the local PE market dropped 16.2 points to -40.4 in Q3, a low not seen since the outbreak of the pandemic in 2020 and, before that, during the global financial crisis at the beginning of 2009. Soaring energy costs associated with Russia’s invasion of Ukraine have recently stifled demand and GDP contracted by 0.2% in Q4, making a recession a real prospect.

The situation is not much better in the UK, where a short economic contraction is expected on the back of poor consumer confidence and falling business output. One bright spot is that central banks appear to be breaking the back of inflation, which should set Europe’s economies on a firmer footing in the medium term.

Despite the adverse economic conditions, Germany still has plenty of appeal as a destination for PE. According to 83% of respondents, the country is a good location for buyout investments, including 29% describing it as very good.

Contrasted against other markets for their forward-looking attractiveness in the next five years, Germany ranks in third. The UK leads with 81% of respondents believing it will become more attractive, followed by the USA (76%), then Germany (68%), France (59%) and the Netherlands (58%). Once the country has overcome the current short-term hump, the Engine of Europe should roar back to life and PE investment will follow.

\(^7\) https://www.statista.com/statistics/256655/private-equity-investments-in-europe-by-industry/

\(^8\) Download PDF: https://www.kfw.de/PDF/Download-Center/Konzernthemen/Research/KfW-Research/Economic-Research/Wirtschaftsindikatoren/German-Private-Equity-Barometer/PDF-Dateien-EN/GPEB-Q3-2022_EN.pdf
Fig. 58  Does your firm currently have any investments such as portfolio companies in Germany?

Yes; 58%
No; 42%

Fig. 59  Do you plan to continue making investments in Germany over the next five years?

Invested in Germany during past 5 years
- Yes; 93%
- No; 7%

Did not invest in Germany during past 5 years
- Yes; 19%
- No; 81%

Fig. 60  Do you think that the assets that you allocate to Germany over the next five years will increase or decrease?

2022 response
- Increase; 58%
- Decrease; 42%

2021 response*
- Increase; 20%
- Decrease; 80%

*2021’s survey results represent a different pool of respondents
Fig. 61  In an international comparison with other countries, how would you assess the attractiveness of Germany as a location for private equity investment?

Fig. 62  In your opinion, which countries or regions will become more attractive for private equity investments over the next five years? – Top 10 answers shown only
E. Methodology
In Q4 2022 and Q1 2023, Mergermarket spoke to 250 PE principals on behalf of PwC. Job titles include: partner and managing director. 13% of these funds are based in Germany and 14% in Benelux countries, with the remaining 73% with offices based elsewhere in Europe. Responses were anonymised and aggregated. All PE firms of respondents had a minimum of €250m of assets under management (AUM).

**Fig. 63** In which country is your organisation’s headquarters based?

**Fig. 64** Which of the following best describes your firm’s current total global fund volume (i.e. capital under management)?
Appendix

Fig. 65 In your opinion, which of the following industries is your organisation most likely to invest in over the next 2 to 3 years? Please name a maximum of 3 industries. (Please choose up to three)

- Consumer: 40%
- Business Services: 37%
- Information Technology/Software: 37%
- Industrial Production/Manufacturing: 27%
- Healthcare: 24%
- Technology hardware: 14%
- Financial Services: 10%
- Pharmaceuticals: 7%
- Food Production: 7%
- Energy & Utilities: 6%
- Real Estate: 6%
- Life Sciences: 6%
- E-Commerce: 6%
- Infrastructure: 5%
- Clean Tech/Renewable Energy: 5%
- Transport & Logistics: 5%
- Healthcare: 5%
- Technology hardware: 4%
- Retail: 4%
- Leisure: 4%
- Telecommunications: 4%
- Chemicals: 4%
- Agribusiness: 3%
- Education: 2%
- Media: 2%
- Automotive: 1%
- Operational improvements (excluding digitization): 32%
- Operational improvements (digitization): 41%
- Financial Leverage: 32%
- Digitisation: 26%
- Multiple arbitrage: 10%

Fig. 66 Please rank the following in terms of importance, regarding their influence on your return on investment. (Please rank 1 to 4, where 1 is the most important and 4 is the least important) – Rank 1 and 2 shown only
Fig. 67  Please rank the following areas of responsible investing in their importance to you from 1 (most important) to 8 (least important)

Fig. 68  In your opinion, which countries or regions will become more attractive for private equity investments over the next five years?
Thank you