North Sky
CAPITAL

Third Quarter 2011

MARKET UPDATE

A Drachma for Your Thoughts

(Europe's Struggles Present Opportunities in Certain Sectors)

The European Union's sovereign debt crisis regained the spotlight in Q3 after investors dealt with the summer's political bickering over the USA's debt ceiling. Not much changed in the EU over the summer. While politicians pointed fingers and banks took steps to add capital reserves, the towering debt, a bleak economic outlook and general uncertainty remain. Half-hearted austerity measures in Greece did little other than to spur more protests. Based on this, investors might avoid Europe entirely; however, we believe this kind of chaos and uncertainty creates opportunity if you have experience, foresight and a longer-term view than the talking heads on CNBC. Before we get to the opportunity, let's review some of the EU data points:

- **Sovereign default risk.** Significant default risk exists among EU countries, including Portugal, Italy, Ireland, Greece and Spain (the "PIIGS").
  - Greece seems increasingly likely to default. If so, does it do so (1) in an orderly fashion with the help of other EU countries or (2) on its own by ceasing to be part of the unified Euro currency (and printing drachmas to repay its debt)?
  - A sovereign default by any one of the PIIGS could lead to a European contagion. This is a very real risk for large holders of PIIGS debt. The European banking system is tightly interwoven, and the increasing risk of a PIIGS default led to the recent downgrade of Societe Generale and Credit Agricole (two of France's largest banks).
  - If a meaningful default occurs, this would further depress European economies as confidence in the creditworthiness of banks decreases, their cost of capital increases, their capital reserve requirements increase and they lend less.
- **Debt Downgrades.** Several countries have had their debt downgraded. Most notably, S&P downgraded Greece's credit rating to CCC in Q2, making it the lowest rated nation in the world. As a result, Greek 10-year bond yields traded above 16%, creating a 1400 bp spread from German 10-year bonds.[1]
- **Unemployment.** At 9.5%, the unemployment rate remains high and has not improved over the past year.[2]
- **GDP.** GDP growth is stagnant and the expectation for future growth has been slashed in recent months.[2]
- **Inflation.** Inflation is expected to reach 2.9% for 2011.[2] Economists debate whether it will stay relatively in check or skyrocket.

The Opportunity

- **Trade barriers remain.** Formation of the EU clearly resulted in local and global trade benefits, yet intra-European barriers to trade remain due to local politics, language and age-old customs (and resentments). In Europe where markets are increasingly interconnected yet still fragmented, it is important to partner with managers who can bridge those barriers. We believe that pan-European or super-regional private equity funds hold advantages over country-specific funds because

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[1] Financial Times and Reuters
[2] European Commission for Economic and Financial Affairs Yearbook 2011

the former can provide contacts and resources for their companies to expand outside their existing markets and an ability to make investments in the most promising geographics.

- **Many European countries remain relatively healthy for buyouts.** The PIIGS regions account for a small portion of private equity activity. For example, only 77 of the 751 buyout deals completed in Europe in 2010 were completed in the PIIGS regions.[2] Further, of the 90 European PE funds raised in 2010, only eight were funds located in PIIGS countries. Furthermore, these funds accounted for a mere 8% of total European PE capital raised in 2010, down from 24% in 2009.[2] PIIGS' economies and consumers continue to be hampered by the fear of future austerity measures while the economic outlook in the Nordic region, for example, remains pretty bright (in part due to the export of natural resources, primarily oil and gas). Sweden, Norway, Denmark and Finland all grew GDP by more than 2.0% in 2010, well above the average for the European Union.[2] Germany also is in this camp, as are others.
- **Not all classes of European PE are worthy.** Venture capital continues to underperform in Europe and the amount of capital flowing into European VC funds has sharply declined, accounting for only 17% of total private equity raised in Europe in 2010.[2] Mega buyouts have not returned to pre-crisis levels as lenders are requiring an increasing amount of equity to finance deals. Leverage for the largest deals fell to 4.4x EBITDA at the beginning of September, the lowest level since 2001. The September leverage level was below the year-to-date average of 4.8x EBITDA.[3] In this low growth, tight lending market, investors should look to lower middle market companies that offer the benefit of market expansion or where business efficiency tools can be implemented. Growth equity investments in cleantech businesses also look attractive, especially those businesses focused on energy efficiency or waste-to-energy.
- **Volatile markets create opportunities to "buy right."** Historical data shows that buyout returns are very strong in the years following recessionary periods. During a recession, acquisition multiples tend to contract and competition loosens, allowing buyout firms to purchase companies more cheaply than during healthy economic periods. For example, the average acquisition multiple in Q1 2009 was 6.5x EBITDA compared to 12.0x EBITDA in Q4 2007.[4] Given economic cyclicality, companies acquired during recessions benefit from general economic recovery that follows, which acts as a tailwind for portfolio company growth. Following a typical 3-5 year holding period, such companies are often sold under stronger circumstances at a premium to the entry multiple, leading to above average returns. While Europe may take longer this time to snap back, the key here is partnering with experienced European fund managers that can recognize which markets are ripe and which still pose too much uncertainty.

Conclusion

Given Europe's troubles and the large amount of global investment capital seeking attractive opportunities, it is important now more than ever, to scrutinize one's exposure to European private equity to maximize the opportunity at hand. At North Sky Capital, we believe an allocation to European private equity is still prudent. Much like our strategy in the U.S., we prefer lower/middle market buyout firms in Europe. We have historically avoided European venture capital and expect to continue to do so with the exception of select cleantech growth investments.

[2] European Commission for Economic and Financial Affairs Yearbook 2011
[3] Preqin.
[4] European Private Equity and Venture Capital Association

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these upcoming conferences:

October 2-5	SRI in the Rockies, New Orleans www.sriintherockies.com
October 17- October 19	FOX Fall Forum, Chicago www.foxexchange.com/
October 30- November 2	US Annual Employee Benefits Conference, New Orleans www.ifebp.org

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