



## **European Investment in the U.S. Private Equity Market**

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Recent research performed with the assistance of 53 European institutional investors<sup>1</sup> indicates that Europe and the U.S. are undoubtedly the most popular areas in which to pursue private equity investments -- only 2% of respondents' capital flows to other regions around the world. In responding to queries regarding diversification, 88% of respondents within the research pool indicated that they have US private equity investments that amount to approximately 38% of their private equity allocations.

Respondents within the research project indicated that they were particularly attracted to U.S. private equity due to its entrepreneurial characteristics, which they believed would continue to fuel returns in early-stage venture capital and small growth and buyout transactions.

Additional research reveals that most European investors see the broader U.S. market as highly entrepreneurial, yet uniform in terms of language, regulation, culture, distribution and other important infrastructure areas, all of which allow small local companies to grow explosively if well managed.

Beyond regional infrastructure advantages, small U.S. companies also enjoy relatively easy access to capital and have well-structured exit markets available through strategic buyers from other domestic and global regions, as well as via acquisitive middle-market private equity firms. Taken collectively, these characteristics are what cause European investors to seek out investment opportunities in the U.S. micro-cap private equity market.

The micro-cap market, characterized by funds with capitalization between \$50-350 million, has generated some of the best returns in the asset class over the past 20 years. According to Thomson Venture Economics, small U.S. buyout funds, which Thomson defines as funds with \$0-250 million in capitalization, have generated 26.7% net to investors over the previous 20 years. Small, "under the radar" fund managers benefit from inefficiencies in the micro-cap segment of the US private equity market. For example, micro-cap fund managers can frequently acquire small companies at reasonable prices through non-auction networks, grow the underlying businesses rapidly through operational improvements and unique opportunities within the US market, and then sell them at attractive multiples into the more efficient, auction-based mid-market segment. The average purchase price multiple paid in 2005 by a micro-cap fund manager for a control equity position is approximately 6.0x ttm EBITDA, while large fund managers have typically paid 7.0x-8.0x ttm EBITDA, or more, for control equity positions during the same period. The return opportunities in the micro-cap market are exceptional; however, there are also significant challenges facing European investors who wish to participate in the segment.

These challenges are mainly focused around access and expertise. Given that these micro-cap funds are relatively small and do not typically have the ability to broadly market themselves in Europe, the funds may be extremely difficult to locate as a European-based investor. Furthermore, these "under the radar" funds are often more difficult to analyze than their larger counterparts, necessitating expertise and dedication to the sector, as fewer

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<sup>1</sup> Executed in June 2005 by Cécile Krikke-Fritz for the Institute of Economic Studies ("HES") in Amsterdam and 747 Capital LLC in New York.



objective data points are generally available for micro-cap funds. Thus it is crucial that an investor benchmark each of the approximately 100 micro-cap teams in the market each year, which is a feat not easily accomplished from a European office. Consequently, to improve the quality of deal flow and investment analysis as a European institutional investor generally requires either a dedicated local presence, participation in a dedicated regional fund of funds, or creation of a relationship with a local intermediary that is responsible for sourcing, analyzing, and ultimately providing investment recommendations for micro-cap fund investments.

In conclusion, it appears that European institutional investors could enhance their private equity returns by allocating a meaningful portion of their private equity portfolio to quality micro-cap U.S. growth and buyout funds. By selecting exceptional, highly motivated teams in inefficient markets, investors can create an opportunity to substantially outperform the 'index,' which should always be the goal as an investor in a market as illiquid as private equity.