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Private equity's sustainable promise

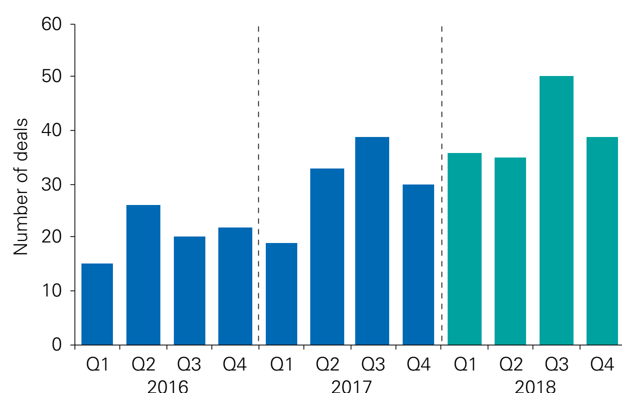
The Swiss economy provided fertile ground for company mergers and acquisitions in 2018, with a record-breaking 493 transactions reported over the course of the year. At USD 132.9 billion, the transaction volume was also up for the third year in a row. Pharmaceuticals, consumer goods and the industrial sector reported particularly high levels of M&A activity. But there was also a strong performer across industries: private equity (PE). PE-based investment vehicles were involved in 160 reported transactions in 2018, an increase of 32% on the prior year. Reserved in the past for those in the know, private equity investment continues to grow. We explore why and examine whether this trend is a sustainable one.

Active contributor in Switzerland

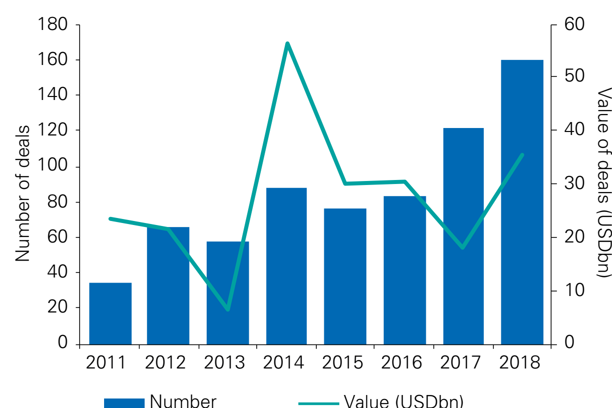
The figures in KPMG's Clarity on Mergers & Acquisitions point to an active private equity landscape. In Switzerland, where acquisitions outnumbered exits, private equity is going from strength to strength.

Buoyed by favorable market conditions, PE firms were involved in almost a third of all M&A deals in Switzerland in the past year, an almost two-fold increase compare to ten years ago. The figures are likely to be even higher including private deals not available for analysis.

Number of deals per quarter



Number and value of deals per year



Cultural shift in Switzerland

Like many alternative asset classes, the private equity model has its origins in Anglo-American investment culture. In Switzerland, it was essentially reserved as a minor component of private or institutional portfolios until fairly recently. Over the past decade, Swiss investors have increasingly discovered the advantages of private equity. Repeated investment and some notable success stories – think Swissport following the Swissair grounding – have raised not only the profile of this asset class, but also investor confidence in private equity. Swiss investors have also got better at embracing a more outspoken style of transaction communication, including a more transparent presentation of profits, multiples and buy-and-build platform strategies. It means that private equity is no longer the reserve of those in the know, but a real option for investors prepared to wait for a return.

Private equity's public service

In the past, private equity houses have sometimes been maligned as ruthless outsiders demanding radical restructuring and profit at any cost. In fact, general partners often invest their own money as well as funds raised from limited partners. Investment is a vote of confidence in a company as it continues along its development path, and the positive effects are not just financial – especially for SMEs. After all, general partners inject more than just capital. Offering expertise, access to an elite network and impetus to change, private equity houses have a vested interest in their targets' long-term success. This also explains the increase in recent years in secondary, or even tertiary, buy-outs between private equity firms.

This powerful mix of cash, strategy and connections does not come without demands, of course. Targets are scrutinized in what can be excruciating detail. General partners are looking for profit down the road, but they've got their eye firmly on the map from day one. Even if returns are not expected immediately, results are. Problem-solving, potentially painful rationalization and process optimization are part of the journey. Looking beyond the individual company, private equity firms support market consolidation by picking out the strongest contenders – a natural consequence of their entrepreneurial perspective. Their role in spin-offs and reorganizations reinforces their position as the economy's gardeners: they weed out struggling divisions but nurture healthy units, enabling them to grow and flourish.

They do all of this away from the glare of public markets and armadas of equity analysts. No quarterly reporting requirements frees up management time and resources to focus on the job at hand. And with an average investment term of four to seven years, management has time to make changes and deliver results without getting caught up with debt repayment pressures or premature IPO. Ultimately, this approach is good for target companies, investors and the health of the economy.

Legal level footing

Depending on their exact structure and business model, private equity arrangements can fall into the supervised category of fund management, collective asset management scheme or common asset management/ trustee. Category, dependent on the actual substance of the arrangement, is important from a legal perspective in Switzerland as it governs the degree of supervisory intensity. Private equity funds should be aware of sweeping changes to be introduced with the new Financial Services Act (FinSA) and Financial Institutions Act FinIA and their implementing ordinances, as well as changes to the Collective Investment Schemes Act (CISA). Expected to enter into force as of 1 January 2020, the legislation aims to increase customer protection, improve consistence across sectors and improve supervision of financial institutions subject to supervision. Based on their substance and activities, PE firms will generally be affected by the new laws and see an increase in supervision. They should begin at an early stage to access the impact of the changes and consider whether any action is required, from tweaking their business model to preparing the authorization application process. Companies concerned about the additional scrutiny and compliance burden can take heart in the fact that the laws level the playing field and potentially improve the competitiveness of private equity firms compared to other financial institutions.

Mainstream alternative?

Institutional investors traditionally account for a significant portion of the private equity market. They typically impose limits on alternative asset classes, which can loosely be divided into the categories private equity, hedge funds, managed futures, real estate, commodities and derivatives contracts. Especially in Switzerland, where prudence and protection are priorities, caution is laudable. But at what point is caution counter-productive? And does private equity really deserve its "alternative" status?

Many Swiss pension funds do not use the entire allowance for alternative investments. Could they be missing out on valuable returns? After all, the differentiation between private and public equity can be arbitrary. Slow trading volumes or sudden price fluctuations can leave listed companies with a de facto liquidity similar to that of a privately held company. And a company's sustainable success depends significantly on its ability to compete in the market, regardless of how its funded behind the scene. Especially in today's low interest rate environment, a change in attitudes may slowly be taking place. Some pension funds are gently challenging the black-and-white view of institutional investment by taking advantage of extension options to push the alternative portion of their portfolio.

Flexibility and profitability

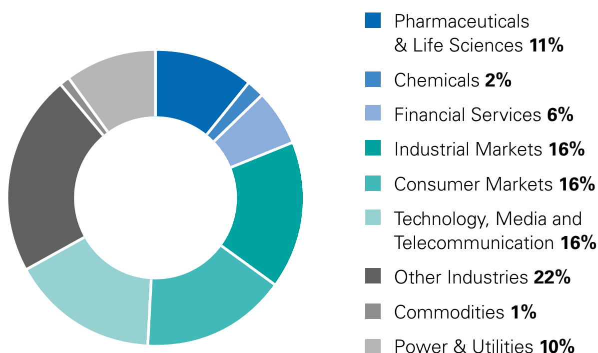
An important advantage of private equity is the cross-sector opportunities it brings. Although private equity houses themselves tend to specialize in a given field, the smaller investors behind the funds stand to benefit from freedom and flexibility in the range of sectors they can support financially. For investors seeking diversity in their investment portfolios, targeted investment in private equity can be an attractive option.

The most popular industries for private equity investors in 2018 were industrial markets, consumer markets and technology, media and telecommunication. This mirrors the top three of overall deal volume and could be interpreted as reflecting the strong business acumen of private equity leaders.

Sustainable outlook and calls for creativity

The PE business model is sustainable per se. Private equity firms rely on a continuous stream of investors to raise funds, so there's an automatic incentive to perform and demonstrate above-market returns. The appeal of this kind of investment vehicle rests significantly on the huge return they've generated in a number of high-profile cases in recent years.

Number of deals per industry sub-sector 2018



It means private equity houses are raising funds in record volumes. Fortunately, the hurdle rate of about eight percent acts as a natural viability filter. Parties investing such a significant stake will only do so if it makes solid strategic and financial sense.

Looking to the future – and potential interest rate rises – will investors be as keen to wait for returns on funds placed with private equity firms? For now, excellent profitability prospects and secondary, non-financial motivation factors make private equity an attractive option, as reflected in the crowded market. To make space and continue to benefit from favorable overall M&A conditions, private equity firms will need to branch out – innovative deal structures, greater specialization and increased diversification are some approaches they might consider. As inherently critical thinkers, private equity leaders are sure to come up with interesting and innovative strategies for future success.

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