



EUROPEAN MID-MARKET

# Mega in the middle

The European mid-market has taken on many of the characteristics of the large-cap space of old, but – say our panel – retains its most important differentiator: the scope for outperformance

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Access Capital Partners  
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From left: Simon Faure,  
Agnès Nahum and  
Christiaan Marriott

Take one look at the fundraising numbers and it's easy to come to the conclusion that raising money for the mid-market in Europe has been plain sailing in recent years. But, as *Private Equity International* discussed with three leading experts in London this autumn, it is not the case that a rising tide is lifting all boats.

With limited partners seemingly upping their allocations to the asset class on a regular basis – almost a third of respondents to our *LP Perspectives Survey 2019* plan to increase their target allocation in the next 12 months – there's undoubtedly a huge amount of capital looking to access this part of the market. But investor needs do not always fit with the funds in market at that moment.

A key issue may relate to fund size. Agnès Nahum, managing partner at private assets firm Access Capital Partners, points out that most of the money raised over the past few years has gone to large-cap and upper mid-market managers; those at the lower end, while still raising capital, haven't amassed as much. "Attracting large pension funds and sovereign funds that have large ticket sizes combined with holding ratio constraints is more difficult at the lower end of the market. It's a different game in terms of raising the money."

Finding strong performing lower mid-market firms in Europe, even in the UK, is challenging, in part because of the mix of quality. This results in less competition at the low end of the mid-market, making it an interesting space to play in, she says.

For the very large limited partners, investing in lower mid-market funds poses a challenge, in part because the maximum ticket size is often too small for the amount of assets they manage.

Nevertheless, funds are being raised. According to *PEI* data, European mid-market funds raised \$43.2 billion and \$42.6 billion in 2016 and 2017, respectively. As of the beginning of November, they »

» raised \$41 billion, which could make it a record year.

“There’s a significant demand from LPs for lower mid-market managers,” says Simon Faure, director at M&G Private Funds Investment.

“There are institutions in the US or in Asia who are running big programmes and they just don’t have the resources or the local knowledge to access the mid-market funds in UK, Netherlands, Nordics or Germany. How do you do that? The answer is to go to a larger pan-European mid-market fund, and that gets you the coverage. Or you have to go through a fund of funds that can get you access.”

Equistone has been successful in its last two fundraisings not just because of its track record, says head of investor relations Christiaan Marriott. The firm’s diversified strategy, focusing on smaller deals in the UK, France and Germany, is appealing to investors.

“If you can go to your LPs and say you’re going to put 25-30 companies in this portfolio – so it’s a big fund – but we’re going to do deals with day-one equity cheques of €65 million, that’s attractive to them because you’re talking to big powerful investors who almost can’t ever stop [committing],” he says.

“When they want to invest in small-cap

funds, then they go through us,” concurs Nahum, adding that Access Capital Partners’ fund of funds programme is made up of around 15 percent emerging teams generally managing small-cap funds between €100 million and €200 million.

“Emerging managers represent a compelling market opportunity as they can offer significant potential for outperformance. We can count circa 80 new teams formed every year in the lower end of the European buy-out segment. They usually raise smaller funds,” she says. “Accessing that part of the market requires a thorough and extensive due diligence due to the specific risks implied by the nature of emerging managers.”

#### FEELING THE HEAT

The participants agree the European mid-market started feeling competitive in 2014 and it hasn’t abated since. What’s more, they don’t see any sign it is getting better anywhere in Europe, and high valuations are slowly migrating to the lower end of the market.

“The competition is harder,” says Faure. “It is harder to find good investments now than it was 10 years ago, and it should be, because there are more investors, more sophistication and more money. People have

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Simon Faure

## HIGH AND DRY

With such ravenous appetite for private equity, GPs with pulling power have been able to push the boundaries in terms of raising money.

Faure, Marriott and Nahum all observe the prevalence of “dry closes” being held by GPs.

A dry close occurs when a firm raises a new vehicle while its predecessor fund is still relatively young. Capital is committed but is not called, nor are fees charged, until the previous fund is sufficiently invested. The practice is a typical feature of a late economic cycle when money is widely available.

“Especially in the UK, managers all want to do the first closing of their fund just before March 2019,” says Nahum. “But we have to wait, so they have to wait. Very often people want to raise rapidly, even doing dry closings, and we try to convince them not to do so because we want the preceding fund to be really invested.”

LPs like Access want to put their money to work and not have it locked down with no capital calls for several years, she adds.

“Sometimes when you have very successful managers, you have to think twice,” Nahum says. “If they are so good and they don’t want to increase the size of their next generation fund too much, we have to consider them, and we will consider investing.”

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As of the second quarter, purchase price multiples for mid-market businesses in the euro zone valued between €15 million to €500 million reached their highest level since 2014 at 9.9x EBITDA, according to the Argos Mid-Market Index, which is compiled by research consultancy Epsilon in conjunction with Argos Wityu.

This was driven by a 4.3 percent increase in the prices paid for lower mid-market companies, according to Argos and Epsilon.

“From 2010 to 2014 you could find deals across Europe with a relatively straightforward story, that were relatively accessible, that had a decent management team, at 6x to 8x,” Marriott says, speaking about the European mid-market as a whole. For the last few years those deals have been regularly trading at 8x to 10x, which has been great for general partners selling assets.

“So the challenge in the last few years has been that if you want to carry on paying 6x to 8x, you’re going to have to roll your sleeves up a bit more and embrace some complexity either in the deal process or in the equity thesis – or you might consider investing in a more ‘safe and steady’ »

» low-growth platform that you think you can inject some growth into through a buy-and-build programme,” Marriott continues.

#### TAKING COMFORT IN COV-LITE

The mid-market has benefited from the growth of private debt funds competing with banks as lenders. As a result, more flexible debt structures are much more readily available for mid-size companies than they were 10 years ago, says Faure.

“The structure of that debt is much more in line with what was available for the large-cap businesses, which will help in the face of a potential downturn,” he says

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recovering and operating in a more regulated environment; they were largely being conservative and that helped to keep a lid on mid-market pricing.

“Then the debt funds really started to penetrate in Europe,” Marriott says. “For us as a buyer of debt, it’s great because you can run these two options together when you look at a deal. Even if we are 10 years on from Lehman [Brothers’ bankruptcy], even if the music is about to stop, I think the mid-market has benefited from that more sophisticated debt market, in many deals having a more robust set of downside protections in the capital structure.”

This should make it easier for companies to trade out of that debt and survive during a downturn than it was during the last financial crisis, Faure says.

“The liquidity should be there,” he says. “The banks last time around worked with the most covenant-impaired large-cap deals because they couldn’t afford to take the hit. They scaled back funding for the mid-market.”

#### MULTIPLE ARBITRAGE

While not immune to macro-economic factors, those around the table agree one of the key benefits of the mid-market is that exit options are less affected by the vagaries of the markets. With the main buyers being larger private equity funds – that have plenty of capital they need to get in the ground – and industry consolidators, it’s tough to see what might spoil the party.

IPOs of mid-market European companies, meanwhile, have been somewhat thin on the ground.

“We last IPO’d a business in 2006,” says Marriott. “We nearly did one last year, but we pulled it. We just decided it wasn’t right. That’s a real attraction for our investors: that we’re not dependent on the IPO window for liquidity.”

More than half of Equistone’s exits are sales to large private equity firms. “But over





## MEET THE ROUNDTABLE

*From left to right*

**Simon Faure** is a director of M&G Private Funds Investment, which he joined in 2004, where he manages a €3 billion private equity portfolio. He has 19 years' private equity experience investing in primary, secondary and co-investments in Europe and Asia. Before joining M&G Private Funds Investment, Faure worked at Insight Investment and AIG Global Investment, both in London. Faure currently serves as chairman of the limited partner committee of the BVCA.

**Agnès Nahum** co-founded Access Capital Partners in 1998 and is now managing partner of the firm. She has 29 years of experience in private assets and was previously a director of business development at Financière Natixis and then at BNP Private Equity. Prior to that, she spent six years with Mutuelle Assurance Artisanale de France where she was head of private equity, managing a portfolio of unquoted investments. Agnès holds a doctorate in law, an actuary's certificate and a Certified European Financial Analyst.

**Christiaan Marriott** is partner and head of investor relations at Equistone. He joined the firm in 2007 from MML Capital and prior to that began his private equity career with Campbell Lutyens. Equistone is an independent investment firm which operates across France, Germany, Switzerland and the UK. It is currently investing its €2.8 billion sixth fund, which closed in March 2018.

the course of 10 years, we have been just as likely to sell that business to a trade buyer that is consolidating a sector, which might be backed by private equity itself," Marriott says. "That scale is the benefit of being in the right part of the size range, to have companies that you don't need to IPO."

Large buyout funds being the big buyers of mid-market businesses has been a boon for firms in that segment, which are taking advantage of the differences in how large-cap firms underwrite deals to inflate prices.

Talking to LPs, there seems to be a 'gulf' of as much as 7 or 8 percent internal rates of return between where large-cap

buyout funds are underwriting deals and where mid-market managers are focused, says Marriott. Some large-cap funds are underwriting deals with gross IRR in mid to high teens, enhanced by an aggressive subscription line.

"The companies that are the real potential winners in that segment are the ones that, even if they are expensive would tend to go on and outperform for the long term," Faure says. "That's why managers are willing to pay for these businesses, because they know they can grow them. The management teams are highly capable to get to the next step." ■