

# **US mid-market 2019**

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**Can the  
mid-market  
stomach a  
recession?**





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## How to contact us

### Senior Editor, Private Equity

#### Toby Mitchenall

toby.m@peimedia.com, +44 20 7566 5447

### Senior Editor, Private Equity, Americas

#### Isobel Markham

isobel.m@peimedia.com, +1 646 380 6194

### Senior Special Projects Editor

#### Graeme Kerr

graeme.k@peimedia.com, +44 20 3862 7491

### Special Projects Editor

#### James Linacre

james.l@peimedia.com, +44 20 7566 5465

### News Editor

#### Adam Le

adam.l@peimedia.com, +44 20 7566 5437

### Senior Reporters

#### Carmela Mendoza

carmela.m@peimedia.com, +44 203 640 7512

#### Rod James

rod.j@peimedia.com, +44 20 7566 5453

### Asia Reporter

#### Alex Lynn

alex.l@peimedia.com, +852 2153 3148

### Reporter

#### Preeti Singh

preeti.s@peimedia.com, +1 646 565 5312

### Contributors

**Amy Carroll, Claire Coe-Smith, Marine Cole, Rob Kotecki and Vicky Meek**

### Managing Editor, Production: Mike Simlett

### Head of Production: Greg Russell

### Production Editors: Daniel Blackburn,

#### Adam Koppeser

### Copy Editor: Eric Fish

### Head of Design: Miriam Vysna

### Senior Designer: Lee Southey

### Designers: Denise Berjak, Glen Reynolds

### Head of Marketing Solutions,

### Private Equity Group:

#### Alistair Robinson

alistair.r@peimedia.com, +44 20 7566 5454

### Subscriptions and reprints

subscriptions@peimedia.com

### Customer Service

customerservices@peimedia.com

### Editorial Director: Philip Borel

### Director, Digital Product Development:

#### Amanda Janis

### Director of Research & Analytics: Dan Gunner

### Managing Director, Americas: Colm Gilmore

### Managing Director, Asia: Chris Petersen

### Group Managing Director, Brands and Markets:

#### Paul McLean

### Chief Executive: Tim McLoughlin

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# Insight

## Key trends LPs want to know mid-market GPs are picking and prepping businesses that will survive a recession

**T**he US mid-market had a stellar year in 2018, especially in terms of deal activity, but some softness is emerging at the margins, **writes Marine Cole**. The environment is marked by asset prices that continue to be elevated and by limited partners who are increasingly preoccupied with how mid-market firms will weather an inevitable economic downturn.

Deal activity in the US mid-market reached a decade-high in 2018 for number of transactions and deal volume. There were 3,072 mid-market transactions in the US in 2018, totalling \$437.7 billion, up from 2,655 deals totalling \$381 billion in 2017, according to data from PitchBook.

However, the beginning of 2019 was slower, due in part to volatility in the public markets at the end of 2018. In the first quarter, GPs closed on 649 deals totalling \$75.1 billion. Q2 figures had not been released by the time we went to press but market participants noted activity had picked up and the total figure for the year could be near 2018's.

### A story about selection

"There was definitely a slow start of the year," says Christian Kallen, a managing director on Hamilton Lane's fund investment team, adding that it lasted until about March or April. "Then it got back to normal. Can we catch up to the end of the year? I am not 100 percent sure, but everything else in 2019 will look very similar to 2018. If we look at our distributions, it looks pretty close to last year."

On the exit side, while initial public offerings continue to be nearly non-existent, secondary buyouts are still the most common route in the mid-market. However, GPs are noticing a decrease in the quality of companies that are coming to market. In particular, there are more companies that have been in portfolios for a long time, or businesses that may have had issues in the past or are simply unsound.

"It feels like later stage," says Vincent Fandozzi, head of North America direct buyouts at Ardian, who focuses on the lower mid-market in the US. "People are trying to use the strength of the financing market and the M&A market to see if they can get something sold. A



lot of them aren't getting sold. It's a story about selection."

In this late cycle, investors are willing to pay a premium for strong companies that will be able to weather a downturn. Companies that have strong predictable cashflow and aren't cyclical are not only being sold easily but are also the ones fetching high exit multiples. Some of these can be found in the healthcare sector, business services and technology, particularly those focused on software.

"In a downturn, everything is going to struggle, but the question is by how much," Fandozzi says. "GPs may be putting a little bit of a premium on businesses with a safer view on cashflow."

Kallen adds: "It feels like everyone in the US mid-market is looking for capex-light businesses with recurring revenue and that are easy to scale."

He notes that the flipside of buying good-quality businesses at high multiples is that GPs are using more leverage to be able to deliver the performance LPs are expecting.

"The positive impact on the operational side gets kind of negated by the financial risk you have to put to be able to buy them," he says. "But this is where you see a lot of growth."



### More risk-taking

Some GPs have been forced to become less conservative than they were about five years ago.

"There seems to be a shift that everyone is now trying to play that kind of market and taking the risk, which obviously will lead to issues down the road at the end of the cycle," says Kallen. "The question is when the end of the cycle will hit and what is the quality you have to put in the portfolio at that point."

These are the types of questions that LPs are increasingly asking their GPs, particularly during due diligence. Delivering good returns is no longer solely sufficient.

"I think some GPs think that as long as we put our head down and deliver

*"The market is more saturated now than it was in the past"*

**Eric Zoller**  
**Sixpoint Partners**

*"In a downturn, everything is going to struggle, but the question is by how much"*

**Vincent Fandozzi**  
**Ardian**

*"The challenge for the GP in the mid-market is really to figure out where we are in the cycle and constructing their portfolio accordingly and making sure they don't get caught with a portfolio with a relatively high leverage"*

**Christian Kallen**  
**Hamilton Lane**

## Big numbers

Facts and figures from across the US mid-market

# 3,072

**US mid-market deals in 2018**  
(PitchBook)

# \$437.7bn

**Value of deals in 2018**  
(PitchBook)

# 999

**Exits in 2018**  
(PitchBook)

# \$10bn

**Texas dealflow 2018. The highest by state**  
(PitchBook)

# 69%

**Proportion of mid-market managers with confidence in the global economy. The lowest level since 2016**  
(National Center for the Middle Market)

good returns, everything should be OK,” says Eric Zoller, founder and partner at Sixpoint Partners. “A lot of GPs are delivering good returns today, but good returns by itself today is not a sufficient differentiator.

“Today GPs need to differentiate themselves by their approach to the market, the edge they have into how they deliver those returns, and most importantly perhaps, by demonstrating they can continue to deliver those returns even as the market continues to heat up and potentially even turns down.”

LPs want to know how a GP will manage its portfolio in a downturn and, as a result, GPs with a strong operational focus are getting increased resonance because they are the ones who will have an edge in managing companies in difficult times.

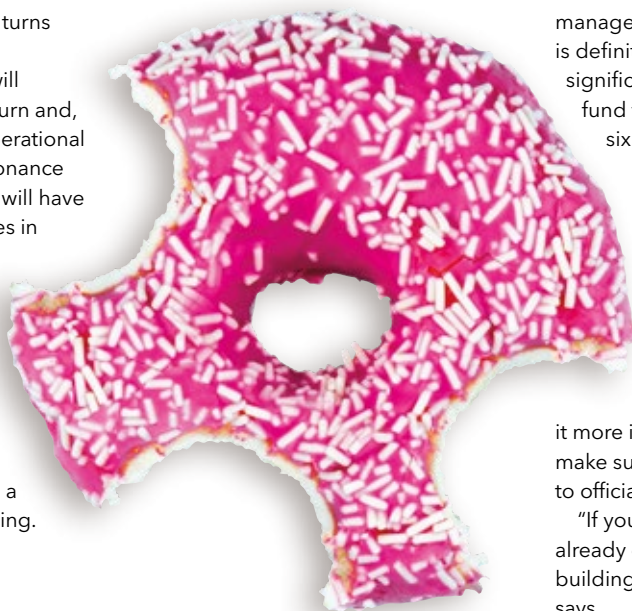
Investors are also focused on managers’ pricing discipline and the interplay between that and investment pacing. They want to make sure GPs are putting the money to work, but they also want to ensure that they are doing so in a prudent fashion by not overpaying.

### A split fundraising market

Zoller observes that overall, the fundraising environment for US mid-market funds has become bifurcated between funds that demonstrate they can deliver liquidity early and raise funds easily and those that are taking longer because they can’t demonstrate liquidity.

“It’s because the market is more saturated now than it was in the past,” Zoller says. “LPs may be looking for an exit from the prior fund, and perhaps a deal in the new fund. If you go back to the 2015-18 period, the market didn’t require the same degree of liquidity or portfolio development, and GPs were still successful in raising a new fund with or without new investments.”

GPs are having to wait to launch their fund until they either get an exit or show an additional investment in the new fund. They may also have to offer a fee break or some other special relationship.



Fundraising figures for US mid-market vehicles fell in 2018 and have continued to decrease this year, but good managers that offer strong liquidity have been able to continue to raise swiftly. US mid-market GPs closed on \$9.17 billion in the first half of 2019, according to *PEI* data. In 2018, that figure was \$33.65 billion, down from a peak of \$50.4 billion in 2017.

The largest US mid-market fundraise in the first half of 2019 was SK Capital Partners V, which closed on \$2.1 billion in February. SK Capital focuses on investing in the speciality materials, chemicals and pharmaceuticals sector.

First-time funds also continue to

attract interest from LPs as Arcline Investment Management, a firm set up by former Golden Gate Capital dealmaker Rajeev Amara, showed when it closed its debut fund in March on \$1.5 billion. The firm’s strategy is centred around buying mid-market industrial businesses.

“Typically, first-time funds or new managers were raising funds with a couple of hundred million dollars,” says Kallen. “You’re now seeing more and more first-time funds and new managers starting with \$1 billion. This is definitely new, that you can raise significantly larger funds in a first-time fund than you were able to do five or six years ago.”

While some funds have a one-and-done close on their fund, this is not the case for all US mid-market GPs. LPs’ calendars are filling up even faster than in the past and they are putting their money to work earlier in the year than they used to, making it more important than ever for GPs to make sure they get on LPs’ radars prior to officially launching their funds.

“If you look at 2019, many LPs are already out of capital and are already building their calendar for 2020,” Zoller says.

What the economic environment will look like in 2020 and whether a downturn will have hit by then is still unknown, but it’s clear that US mid-market funds and their investors will have to continue to put a greater emphasis on making sure portfolio companies are ready when it comes.

“The challenge for the GP in the mid-market is really to figure out where we are in the cycle and constructing their portfolio accordingly and making sure they don’t get caught with a portfolio with a relatively high leverage that might get them into trouble if the revenue and EBITDA growth stops,” says Kallen.

“It really comes down at the end of the day to what is going to be the catalyst that makes the cycle enter the downturn, and the macro-economic environment will be the biggest challenge for the mid-market.” ■



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## Editor's letter

# Hungry for more of the mid-market



**James Linacre**

james.l@peimedia.com

The US mid-market's praises do not get sung often enough. As the biggest beasts and smallest minnows capture attention, the companies in the middle keep powering forward. Private equity mid-market dealflow was up \$57 billion in 2018 compared with 2017. A deal count of 3,072 was more than 400 greater than the year before.

Taking the National Center for the Middle Market's definition of mid-market (companies with revenue of \$10 million-\$1 billion), it is a sector that has accounted for some 60 percent of job growth in the US over the last eight years, with revenue in the last year that was 6 percentage points higher than companies in the S&P 500. Private equity-owned mid-market companies were a significant part of that.

The question is whether this strong performance can last, and there are plenty of voices calling for caution. Some GPs are responding by going global, looking to expand portfolio company activity across the Atlantic where once they would have focused on domestic buy-and-build strategies.

Within the US, there is a greater emphasis on selection. With concerns that the market is into the late cycle, investors are paying a premium for companies that are expected to fare better in a downturn.

That has created a two-tier market, in which companies with strong cashflows and which are not viewed as cyclical are attracting a lot of attention, whereas others are struggling to be sold. GPs note there has been a decline in the quality of companies coming to market.

Fundraising stalled at the start of the year as these concerns took their toll, although it has since recovered. Investors have been sweet on the US mid-market for a long time now and developed a taste for it. Although they are increasingly looking to the horizon, their appetite is still strong – it is just that their palates have become more discerning.

**“ Companies with strong cashflows and which are not viewed as cyclical are attracting a lot of attention ”**

**James Linacre**



### New York

130 West 42nd Street  
Suite 450  
New York  
NY 10036  
T: +1 212 633 1919

### London

100 Wood Street  
London  
EC2V 7AN  
T: +44 20 7566 5444

### Hong Kong

19F On Hing Building  
1 On Hing Terrace Central  
Hong Kong  
T: +852 2153 3240

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## KEYNOTE INTERVIEW

# Trade war threats and opportunities



*As protectionist trade policies impact supply chains of mid-market American businesses, private equity firms are both winners and losers. Baker McKenzie partners Michael Fieweger and Mark Mandel discuss the impact on pricing and portfolios*

### **Q What impact is the US protectionist legislation having on mid-market private equity transactions today?**

**Mark Mandel:** The trade war began last year when the President responded to the huge trade deficit with China by imposing tariffs on billions of dollars' worth of Chinese products. He also opened a now completed renegotiation of the North American Free Trade Agreement by imposing import tariffs on both Canadian and Mexican goods as part of that renegotiation.

The number of goods and businesses impacted is staggering, and those private equity portfolio companies that are buying products from China as part of the supply chain have seen costs go up, while those that source goods in Vietnam, India or

neighbouring nations have gained an advantage as a result. There are no clear winners or losers, it simply depends what the supply chain of each business looks like. If you're a private equity firm that owns a company that manufactures in China you are having issues, but if you own a portfolio company in a neighbouring country it's a bonanza while trade negotiations continue.

**Michael Fieweger:** There are two competing goals behind US foreign trade policy. One is the promotion of the President's mercantilist America First trade policy, and includes the imposition of tariffs, the

reopening of NAFTA and termination of participation in multi-lateral trade talks.

The other is national security, which is manifested in increased scrutiny of and acquisitions of technology companies and increased scrutiny of IP transfers, particularly in areas like 5G. It is not always clear what goals the administration is pursuing and, as a result, it is not clear as to what may or may not be an acceptable solution to the trade sanctions imposed by the administration.

Trade sanctions driven by the promotion of trade policy and national security interest have differing effects on private equity investments. Enhanced national security reviews for example are impacting mid-market deals, largely removing Chinese buyers from the market and creating concern from other foreign buyers and limiting the

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market for the services provided by high tech companies.

That impacts the calculus as you go into technology deals in areas like software or software services, because one has to consider whether there are aspects of the business that could be subject to limitations on the transfer of technology, which maybe were not an issue in the past. Or, are those businesses likely to be the focus of potential backlash legislation from other countries in the future?

**Q Which sectors and types of portfolio company are feeling the greatest impact, and why?**

**MF:** There are some sectors that are seeing less activity. A client was looking at a deal where the end markets are tied to the agricultural markets. Interest in the target was very low, because US farmers are being hit badly by the tariffs being imposed in China. Sectors hit hard by the trade war like agriculture are a tough place to play these days.

Across industrials it has not been easy, because notwithstanding the intent to benefit US manufacturing, the supply chains of even heavily US-centric companies are being negatively impacted. Most middle-market US industrial companies have supply chains which are heavily dependent upon trade with China, Mexico and Canada.

The presence of existing tariffs and constant threat of new tariffs creates significant risk when looking at a US manufacturer. Clients are looking carefully in those situations at how much pricing power the companies have and their ability to pass on the increased input costs to customers.

Technology is being impacted in certain segments, but overall that market remains pretty strong, particularly in the middle market where a lot of investments in technology-enabled services do not see a lot of impact from the tech transfer focused sanctions.

On a macro level, we are seeing a decline in cross-border investment and people are putting money to work closer to home. Asian investments into the US have really dropped off. A lot of that can be attributed to the trade war, but it is also really expensive to come into the US at the moment as a foreign fund and outbid local players.

**Q How do you see the policies creating opportunities?**

**MF:** If you are a private equity fund that is operationally-focused and used to working

*“Enhanced national security reviews are impacting mid-market deals, largely removing Chinese buyers”*

**MICHAEL FIEWEGER**  
Baker McKenzie

with companies with complex supply chains, there may be some value to be added by repositioning supply chains moving production and sourcing out of China into other South-East Asian countries. If the fund and management are willing to put in the work there may be opportunities where the targets have been negatively impacted by the trade wars.

There is also a calculation to be made about whether this all dies down through the hold period. In some of those sectors being hit hard, there is a buying opportunity because this will hopefully be resolved by the end of your hold period.

**MM:** These policies have created opportunities but they are not without risk. We are in a period of transition, because it is likely that the policies are going to change. The trade wars could be resolved like with NAFTA or they could expand in intensity and scope.

Nevertheless, we are still seeing some private equity firms purchasing companies that manufacture in these neighbouring countries. They are betting in the medium term the tariff wars will be resolved favourably.

**Q What can private equity firms active in the market do to mitigate the impact of protectionism and regulatory uncertainty?**

**MM:** In the context of private equity funds buying companies that are lower-cost

producers because they are not subject to higher tariffs, we have crafted provisions that provide that if a tariff were to be imposed on a product, the seller would have to pay damages to the buyer. The parties negotiate a formula that applies to determine damages.

Either the parties can share the pain or the seller can bear all of it. We have seen this in the form of indemnification on purchase price provisions. We have used these provisions a lot since the beginning of the trade wars.

Right now, private equity firms are trying to get to a view on what is the new normal, and once they feel comfortable, they will start to operate their businesses under that construct. It may affect how they put money to work. In the short term, until the trade wars are resolved, they may shy away from businesses that have more exposure to tariff risk. However, deals are still getting done and private equity funds still have money to deploy, so they can price the risk into the deal or negotiate the indemnification or purchase price adjustment provisions to limit the risk.

**Q What advice would you give to any mid-market firms that are concerned about this?**

**MF:** The protectionism and the trade war are not going to go away any time soon, so the advice is to be thoughtful about their impacts when you are making investments and when you are addressing issues with your portfolio companies.

There are both negative and positive impacts, and that discussion needs to be an item on the board agenda.

Attention needs to be paid to the impact on supply chains, earnings, contracting with customers and suppliers, and how acquisition and partnering opportunities might be created. Some of the best private equity firms are looking at this as an opportunity, a way to distinguish and a way to use thinking around these challenges to create and unlock value.

Companies need to be thinking about how they plan for a prolonged trade war and what the knock-on effects might be, not just in the US but also elsewhere in the world. The political circumstances that have resulted in us getting to this point are not unique to the US, so we should not necessarily expect this to blow over resulting in free and open markets everywhere. ■



# On the minds of industry leaders

*How are mid-market CEOs and CFOs managing the long-lasting expansion of their industry, with its high asset prices, sophisticated LPs and cutting-edge technology?*

## Our mid-market panel

**Nathan Brown**

Managing director, Wind Point Partners

**Omar Hassan**

Principal and CFO, Cloverlay

**Heramb Ramachandran**

CFO, XPV Water Partners

**Brian Ramsay**

President, Littlejohn & Co

**Alex Slusky**

Founder and CIO, Vector Capital

**Béla Szigethy**

Co-CEO, The Riverside Company

**Ted Virtue**

CEO, MidOcean Partners



## Q What is the biggest challenge facing you in the next few years?

**Heramb Ramachandran:** Supply and demand. There is an abundance of private capital and a finite amount of deals. Valuations remain high, and I don't see this reversing any time soon.

**Brian Ramsay:** Sourcing new deals at a reasonable valuation will continue to be our biggest challenge over the next few years. Since the great recession, a winning PE strategy has been to buy great companies for whatever it takes to prevail and then benefit from expanding multiples on exit.

This approach has become a very crowded trade, however, and PE buyers have started to stretch their definition of 'great' to include companies with more complex stories. This will at some point play to our strengths, so even a mild economic softening or financial market hiccup should lead to interesting opportunities for Littlejohn

as a value investor with unique distressed and special situations capabilities.

**Ted Virtue:** With all the capital that has moved into PE, we need to remain disciplined to where we have a knowledge-based advantage. We need to continue to have the best knowledge, networks and management resources in the sectors where we invest.

**Omar Hassan:** It's talent retention. This means we have to build an attractive culture beyond compensation. So we treat everyone like owners here, and make sure everyone feels their contribution matters.

**Nathan Brown:** The biggest challenge is to continue developing best practices that allow us to succeed as the market continues to become more competitive. We meet quarterly to assess how we can improve in all areas of firm activity: deal sourcing, CEO recruitment and assessment, value-creation plan development and deployment, and others.



### Q How is the relationship between GPs and LPs evolving?

**OH:** They're more sophisticated, and looking for a continuous collaboration with GPs. We'll have periodic updates with LPs about our pipeline and discuss things we've passed on that might still make sense for them in a different area of their portfolio. LPs aren't just clients; they're partners.

**Béla Szigethy:** It's constantly evolving for the better, meaning greater transparency in both directions: LPs being clear about what they want and GPs being transparent about what we expect to deliver.

**BR:** For the last several years, LPs have been looking to deepen their connections with PE firms they view as priority relationships. This might mean committing larger dollars to a smaller number of GPs, seeking co-investments with trusted firms or supporting the growth of PE firms by allocating to their new strategies.

**NB:** GPs and LPs are finding more ways to collaborate and add value to one another. LPs have become more sophisticated on how to leverage their experience and network to bring ideas and new capital to GPs. We've benefited from LPs bringing us deal ideas, referrals to executives and secondary opportunities.

**Alex Slusky:** The days of only spending time with LPs around fundraising are gone. We are in constant communication with our LPs and we often approach them early if we are pursuing an especially large deal that we may not otherwise be able to complete on our own, or seek a complex financing package. They've become true partners to our business.

### Q Are you diversifying?

**OH:** We're a relatively new firm that launched in 2015, and we feel LPs would like us to stay true to our core competencies.

**BR:** For nearly 25 years, our focus has been to deploy capital in situations that can benefit from some sort of transformation. We started with control private equity, then added expertise and solutions in special situations and distressed debt. More recently we have built teams to invest in performing credit and more highly structured capital solutions. When an opportunity arises to use that knowledge to support a business transformation, we want to be able to say yes.

**TV:** MidOcean diversified into credit in 2009, where we now manage over \$8 billion in assets across a number of strategies in corporate debt. These credit strategies stem from our specialised experience and expertise in the mid-market, drawing on the strong industry-focused network of contacts our team has built up over close to two decades. We now manage two long/short credit strategies, several long-only mandates and a number of customised credit vehicles, in addition to a fast-growing CLO business.

**NB:** We have been investing in three core sectors over the past 20 years, which has given us diversification. However, we're constantly analysing the market trends within those sectors and shifting to where we see the most opportunity. Lately, we are focused on markets and business models that are high free cashflow and recession resistant.





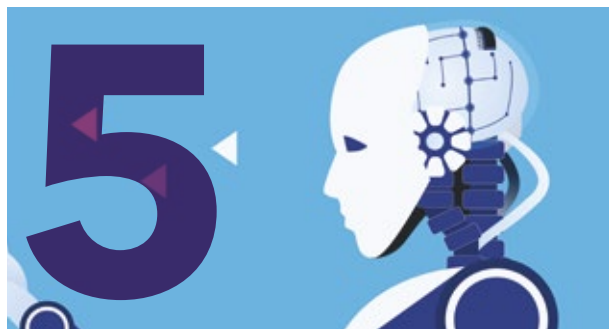
### Q What issues keep you awake at night?

**BR:** The biggest risks to deals and portfolio companies right now are geopolitical. The ever-widening political divide in the US and many other countries is fuelling alarming policy initiatives from both ends of the political spectrum. While we have contingency plans in place, we are obviously limited in our ability to mitigate these risks.

**BS:** With a broad portfolio, lots of folks tending to their own companies, somebody doing something stupid along the way is always a concern. Compliance-related issues and headline risks can really hurt an investment.

**NB:** We're benefiting from this strong market, so we're currently sleeping well! We have tried to build a portfolio that will perform well in a recession, so that we can continue to sleep well. But each recession has different characteristics and it likely will provide challenges that keep us up at night when it comes.

**AS:** Rarely does a month go by when I don't read about another large pool of capital increasing its allocation to private equity. They look at how PE has outperformed other asset classes over the last 20 years. This flood of money is depressing returns and distorting incentives across the entire industry.



### Q How is artificial intelligence changing things?

**HR:** AI is a potential game-changer in the sourcing of deals. The sweat equity devoted to building up a pipeline that currently might take months and years could potentially be replaced by data-mining bots with real-time analytics.

**OH:** AI's chief contributions are going to be the back and middle office, where it can address recurring tasks. To me, it'll be a cost reduction exercise.

**BS:** Each of our portfolio companies is in some way benefiting from AI. I would love to see our own firm use AI to help make better investment decisions. We have a broad universe of companies and experiences for an AI algorithm to draw upon. Can't wait!

### Q Are you launching a secondaries process to provide liquidity to investors?

**NB:** We closed a secondaries process on a 2006 vintage fund last year. We had three portfolio companies remaining and had recently recruited new CEOs and developed a new value-creation plan at each company.

We were able to get an attractive offer from a new investor that ended up being a win-win-win solution for the original LPs, the new LP, the GP and the portfolio management teams. We don't see a need to launch another process in the near future as we are seeing some early liquidity events on our more recent funds and hope to manage those to a 10-year life.

**BS:** We have provided investors in older funds some assistance in finding buyers for their positions. We would like to do more here, since investors in general are seeking liquidity more often.



### Q What is a trend that doesn't get enough attention?

**TV:** Over the past 15 years, virtually every mid-market PE fund has transformed from a generalist fund to a sector and geographic-focused fund. Sector knowledge is now table stakes to effectively source and operate successful companies.

**NB:** We have seen the need for minority equity or preferred equity increase in the mid-market. We have accessed capital from other private equity funds to meet this need in our own portfolio.

**OH:** The use of operating partners might face greater scrutiny. There's room for conflicts of interest and perhaps LPs are paying too great a share of the cost. I expect more transparency around these fees in the future.

**BR:** While great companies get pre-empted at jaw-dropping multiples, an asset that has even a little hair on it may find that nobody shows up at auction. The leverage markets are similarly bifurcated. Some bank deals are two times oversubscribed at record tight spreads, while for others, the underwriters can't find a bid. In this environment, some of these 'busted' deals are worth a closer look. ■





# Building a mid-market co-investment portfolio



Guest comment by **David Smith** and **Oliver Schumann**

## *Intelligent portfolio construction can create outperformance and simultaneously mitigate risk over multiple market cycles*

Over the last decade, co-investment funds have continued to develop and professionalise as the early approach to making individual co-investments often led to unsatisfactory returns. Here, we make the case for taking a global, actively managed and well-diversified approach to building a mid-market co-investment portfolio. We show that this approach leads to outperformance while reducing risk over multiple market cycles when compared with conventionally built portfolios. We call this ‘intelligent portfolio construction’.

### **The secret of success**

Independent academic research on the topic of co-investment has shown that a key success factor is the presence of a dedicated primaries platform with a broad and deep network of several hundred top-performing private equity fund managers. The scale of co-investment dealflow derived from this network permits the adoption of intelligent portfolio construction.

This expansive network complements the skillset co-investment managers should have to enable proper, comprehensive assessment of the characteristics of target companies and their management teams. The intelligent portfolio construction approach encompasses multiple diversification factors, including geography, sector, pacing/vintage and lead investor.

Empirical analysis of more than 1,000 co-investments among over 13,000 private equity transactions completed from 1981 to 2011 shows there is no so-called ‘adverse

selection’ and co-investments generally outperform investments not offered for co-investment by private equity managers. This outperformance is primarily attributable to the lower costs of a co-investment fund versus those of a typical mid-market private equity fund (ie, approximately half the annual management fee and carried interest). Over this 30-year period, outperformance appears more frequently than underperformance and, on occasion, it can be substantial.

Intelligent portfolio construction also provides far greater downside protection than would be typical of a randomly selected buyout fund constructed by a single fund manager. To explore this, we conducted advanced proprietary simulations on 268 private equity funds with vintage years of 1995-2010 and their 4,739 underlying portfolio companies and found that, by using the spread between the median and lower decile measures of total value to paid-in capital (TVPI) as a measure of risk, a co-investment

fund mitigates risk by 67 percent versus that of a randomly-selected buyout fund (ie, a co-investment fund posts an increase in lower decile TVPI of 67 percent).

### **Anticipating change**

An experienced co-investment team adds value by capturing trends that take account of market cycles, deliberately over- or under-weighting a portfolio by region, sector, transaction size and/or structure. For example, emerging from the last crisis, there were good opportunities to invest in mid-sized industrial businesses with international expansion potential, particularly in Asia.

Later in the economic cycle (2014-16), the co-investor was offered the opportunity to invest in transactions with high-value creation potential, especially in software and services. More recently (2016 onwards), co-investors have looked for transactions that provide a higher degree of downside protection to safeguard against increased volatility. These examples reflect trends that experienced co-investment managers have followed over the last decade or so.

Academic research and advanced simulation studies confirm that investing in a global, well-diversified and actively managed co-investment fund can be an attractive way of generating outperformance, mitigating risk over multiple market cycles. ■

*“An experienced co-investment team adds value by capturing trends that take account of market cycles”*

David Smith is senior managing director of Capital Dynamics’ co-investment team.

Oliver Schumann is managing director of Capital Dynamics’ co-investment team.

## KEYNOTE INTERVIEW

# Making the mid-market breakthrough



*There may be plenty of opportunity in the US upper mid-market buyout arena, but there's also a lot of competition. European entrants need to stand out from the crowd, says Ardian's Thibault Basquin*

As the private equity industry becomes increasingly global, not only are US firms establishing themselves in European markets, but increasingly European firms are expanding operations in North America, particularly in the upper mid-market. Yet breaking into this space is not for the faint-hearted – it may be one of the most active segments of private equity globally, but it's also fiercely competitive.

In the autumn of 2018, private investment house Ardian expanded its flagship European direct control buyout fund into the North American upper mid-market. Thibault Basquin, head of Americas investments for Ardian Buyout Fund, explains what it takes to strike a different note in the market.

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### **Q Why did Ardian Buyout decide it was time to establish a team in North America, particularly given the level of competition?**

North America is a very interesting and large market and we know this because it is not new to us. Ardian has been in the market for 20 years through our secondaries fund of funds business and our infrastructure team, so we have already developed strong networks.

However, over the past 23 years, our direct control buyout team has also built out many European businesses globally, including in North America; of the 130 add-on acquisi-

tions we've completed over the past 10 years, 30 percent have been in North America. Our US team is leveraging these foundations to build out our investing opportunities here.

### **Q And how are you seeking to do that?**

We are selectively focusing on identifying cross-border transatlantic opportunities with a European angle, and that makes us substantially different from our US peers. We will take majority stakes in upper middle market companies with the goal of helping them grow and diversify internationally. Our focus is on companies with an enterprise value of around \$400 million to \$2 billion where we can provide equity cheques of a minimum \$200 million.

Given North America is a key destination for our European portfolio companies, it's invaluable having a local team on the ground to strengthen our expansion opportunities in this region. And vice versa, we have locally empowered teams in six offices throughout Europe that can really help North American companies accelerate their European expansion strategies. We also have deep relationships with the key European corporates and families and we want to build on our reputation for being the family business partner of choice. In our sixth buyout fund, for example, 60 percent of the deals we did were first-time buyouts primarily completed alongside families.

### **Q Which sectors do you see as attractive in the US market?**

There are a number of attractive sectors, but we have a long track record and strong experience in the food value chain, and health and wellness. These are also sectors that fit neatly with our sustainability agenda.

For example, through several add-on acquisitions we have helped make Kersia, which provides biosecurity solutions, one of the largest groups globally focused on food safety. In health and wellness, we invested last year in Inula, a major natural remedies business.

### **Q Can that also help to mitigate high valuations?**

It can, although we are prepared to pay good prices for good quality assets and families are generally well advised and have a clue about what their company is worth. Valuations are high and will remain so for some time to come. There is so much private capital available in the market and not much sign of that slowing down.

### **Q How are family businesses different when it comes to private equity investment?**

When you invest in a family business, you need very good soft skills and a history of relationship. When a family business has been very successful in the past, the owners and managers clearly know how to run their business. Private equity's role is usually about transitioning, reinforcing management teams, implementing a tailor-made value-added governance and professionalising processes and systems. It's important to tread sensitively.

When we invest in family businesses, we also ask the owners to reinvest a proportion of

their proceeds into the company – in order to keep usually between 20 percent and 40 percent of the share capital. That is powerful because it signals to employees, customers and suppliers that the family is very much committed to the company's continuing success and creates a strong alignment of interest.

### **Q You mentioned sustainability. Why is it important to you?**

This has become more important as the shift towards private capital looks set to continue increasing. It's true that it's a hot topic now, but we've been working on applying sustainable principles for more than 10 years. We were an early signatory to the Principles for Responsible Investment. We have a duty to all our stakeholders to behave in a responsible and sustainable manner. It's an area where Europe has really taken a lead and, because our firm has been committed to sustainability for so long, we believe we can bring something different to North America.

Our commitment has to be holistic, so it's at the heart of what we do on a daily basis, from managing our investment portfolio through to the way we operate as a firm. Since 2008, with the management's agreement, we have also shared a portion of the capital gains we make from investments with all employees in portfolio companies. You have to consider the contribution all employees make – not just management and owners – to creating value in a business. Since we launched that initiative, we've distributed more than €48 million to over 20,000 employees.

### **Q How else do you work with portfolio companies when it comes to sustainability?**

In 2015 we were one of five French private equity firms to launch the Initiative Climat 2020, which aims to reduce carbon emissions in majority-owned portfolio companies for which the subject is considered material. Since 2009 we have created, in conjunction with management teams, an ESG roadmap for each of our portfolio companies – that's more than 100 businesses. Roadmaps are monitored and updated every year.

Portfolio companies find this very useful as it enables them to communicate progress both internally and externally, and they can see the impact of what they are doing. It helps us because we can provide easy, almost instant access to ESG KPIs to LPs, who are increasingly seeking more information on sustainability.

### **Q What about Ardian itself? How do you apply sustainable practices within the firm?**

This is fully integrated in our firm and encompasses everything we do, from leveraging young talent via our millennial committee, which feeds back to our board on what we should be doing, through to ensuring we promote equal opportunities in our firm.

We established the Ardian Foundation, which is focused on promoting education and social mobility, 10 years ago – that has so far had over 200 beneficiaries and around 30 percent of our staff are involved with it. Also, as a firm established by a female leader – Dominique Senequier – female participation in our organisation has always been important, and we established a women's club a year ago to support the development of our staff.

We also run initiatives such as a disability employment week. We have the Ardian Green Challenge as well, an employee-led initiative, which aims to reduce waste in our organisation, including reducing packaging and water and energy consumption.

Lastly, our firm is majority-owned by our employees, with around 70 percent of employees invested in the management company. As with our portfolio companies, we want to ensure that all employees have the opportunity to share in the value they create.

### **Q And how will this approach develop in the future?**

We now have a 10-year track record of viewing our organisation and our portfolio companies through a sustainability lens and it's clear that this has contributed to our growth; maximising financial returns and creating sustainable value for stakeholders are not mutually exclusive, they are intertwined.

Now, we believe we need to quantify more precisely the impact we have so we have decided to measure this using the UN's Sustainable Development Goals.

We're working to develop a method of measuring and reporting how portfolio companies manage their operations on a daily basis, what their impact is on the supply chain, their customers, and their products and services.

We're continually looking for ways of improving what we do and as pressure increases on the private equity industry to demonstrate sustainable returns, we want to continue to be at the forefront of developments. ■



# GPs go global to create value

*A high purchase price environment is forcing US mid-market GPs to become more creative and global in their approach, **Marine Cole** finds*

Purchase price multiples remain high overall in the US mid-market even if, depending on the company and the sector, they may be topping out. It is still common to see companies trade at 20x EBITDA, mid-market private equity investors say, a phenomenon often driven by widely available leverage at a low cost.

For several years, US mid-market GPs have focused on buy-and-build strategies, purchasing high-quality platform companies, which often come at high valuations, and averaging down their costs with smaller add-ons at lower valuations. The reliance on add-ons to create value has only gathered steam in the past year.

GPs are also holding companies longer and relying on dividend recaps to boost returns to LPs or are, increasingly, using the secondaries market to lengthen the hold period of a company through GP-led transactions, such as transferring assets that need more time into a continuation vehicle.

Along with such strategies, GPs are also being more selective about the auctions they participate in. They are avoiding large auctions as much as possible and instead try to take part in the smaller ones. This is one route Ardian has taken for example, according to Vincent Fandozzi, head of North America direct buyouts at the firm.

"We're being more selective about what we're looking at and we're focusing on smaller processes," he says.

"We're also looking at much more complex situations that you have to work a little harder at to understand where the value creation is. It means you have to diligence a little bit more, roll your sleeves up around

the thesis and what you're going to do with the company."

Managers try to get ahead of auctions by analysing other GPs' portfolios and identifying companies that are likely to come to market. They either buy the company before it reaches an auction process or study a particular asset closely to be able to move quickly and be in a lead position once it hits the block.

## Taking a global view

US mid-market GPs are also taking advantage of global opportunities. Firms, particularly those in the lower mid-market, have historically been heavily centred on North America. This is in contrast to the European mid-market, which has a deeper international mindset, in part due to the fact that it is a sum of different markets.

In the US, "people are a bit shy to cross the Atlantic", says Thibault Basquin, head of Americas investments for Ardian Buyout Fund, which focuses on the upper end of the mid-market. "In Europe, they have to."

However, this is changing slowly. "More and more, US mid-market companies are willing, or will be willing, to expand outside of their existing territories," Basquin adds. "It's a question of maturity of the market. Because the US market is very large and is deeper and more mature than the European market, it's true the US market offers plenty of consolidation and development opportunities. Having said that, in some sectors, you will need to have a global presence."

This is true for software companies, healthcare companies, manufacturing companies, food chain-related companies and, generally speaking, companies in sectors



that have global clients and proximity to them is key.

Basquin moved to Ardian's New York office in 2018 after spending 20 years in the firm's Paris headquarters to focus specifically on transatlantic opportunities for the GP's mid-market portfolio. His role includes looking for add-on acquisitions in North America for European portfolio companies and assisting North American mid-market businesses in their expansion into Europe.

Ardian is not the only firm with global ambitions for its mid-market segment. In recent years, many European mid-market firms such as London-based Bridgepoint (which owns *Private Equity International's* publisher PEI Media) have also set up offices in New York to find US add-ons for their European businesses.

Taking a global outlook for portfolio companies can help US mid-market GPs boost growth, create long-term value and make a company more appealing to sell. It can also help them avoid cyclicalities.



*“More and more, US mid-market companies are willing, or will be willing, to expand outside of their existing territories”*

**THIBAUT BASQUIN**  
Ardian Buyout Fund

In the global financial crisis, it was clear that different countries reacted to the downturn at different speeds due to variations in supply chain, local regulatory considerations or even political behaviours. Being more geographically diversified makes a company more stable and more resilient, a key strength at this point in the cycle. “The company will be perceived as less vulnerable,” Basquin says.

Even if it is challenging for a US mid-market GP to expand its business globally, it can take advantage of foreign buyers interested in North American add-ons to sell its portfolio companies to.

#### **Mitigating risk**

However, taking a global approach and venturing into new markets isn’t risk free. US GPs need to deal with different cultures, regulations and political systems. They also have to manage currency risk.

“It’s a critical topic,” says Basquin. “One way to mitigate currency volatility is to

make sure we will have local production. You can also try to put in place local financing, one of the issues being the local rate of the financing for sure, but there are ways to be creative.”

Another risk for US mid-market firms with businesses that are more global is the recent trade tariffs that have been imposed by the US and then in turn by other countries in retaliation.

While the trade wars, in particular with China, have not significantly affected the US mid-market directly yet, GPs continue to see it as a concern. For now, there’s uncertainty as to the extent of the impact.

“You see it here and there,” says Christian Kallen, a managing director on Hamilton Lane’s fund investment team.

“One or two portfolio companies in some funds have margin compression, but it’s more a short-term intake than anything else.”

Fandozzi at Ardian also notes that it has affected a couple of companies, but they have adapted to the changes. For example, some of its businesses are sourcing out of China where higher tariffs have been imposed, and instead of selling those products in the US, which would be more expensive due to the tariffs, they are selling globally.

The question remains whether it is going to be a temporary nuisance or a permanent challenge.

“Eventually it will all be pushed to the consumer through higher prices and will not have a meaningful impact on the company for the medium- to long-term as companies are reacting to it through cost saving and price increases,” Kallen says.

“The big impact will be if people believe that there’s permanent trade uncertainty. People will stop investing and will stop spending, and this might be the catalyst or the trigger for an economic downturn, and it would have a much broader impact on private equity and the economy as a whole.” ■

## KEYNOTE INTERVIEW

# Creating value later in a fund's life



*Firms are having to work longer and harder to achieve attractive returns, but sourcing capital to drive growth late in a fund's life can be challenging, says **Tom Glover**, head of fund finance, Investec North America*

**Q It is widely considered that we are nearing the top of the cycle. How is the US mid-market responding?**

We are in the longest-ever period of economic expansion, yet US stock indices have traded down from recent all-time highs, we are struggling with a trade standoff with China, the yield curve has inverted and the Fed is cutting rates as an economic insurance policy. These factors taken together would suggest that the top of the cycle is near or even in the rear-view mirror, but the unanswerable question is how long this expansion will continue.

In terms of the US mid-market M&A environment, valuations remain high, but multiples have actually been hovering near today's levels for over five years. Following the Great Recession, acquisition multiples spiked in 2014 and have since remained range-bound.

What the data doesn't show, however, is that EBITDA adjustments have become

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more pervasive and substantial – as we have been seeing in the leveraged finance market as well. So, when people are quoting multiples on deals now, they are likely to be based on more substantially adjusted EBITDA than would have been the case five years ago. When you take that into account, entry valuations have continued to climb.

**Q What impact is that having on how sponsors approach value creation?**

With high entry valuations and many firms modelling lower multiples at exit, sponsors have to work harder and longer to deliver attractive private equity returns.

We are seeing sponsors deploy larger amounts of capital – relative to initial platform cost – in sophisticated and aggressive buy-and-build strategies.

The objective is often to create companies that both appeal to strategic buyers and have increased organic growth and margins, all of which can have a big impact on multiple expansion at exit. It comes as no surprise then that hold periods are lengthening.

**Q Does this mean that the traditional fund structure is unsuitable for modern value creation needs?**

Private equity firms operating within traditional fund structures continue to deliver strong investment returns. But the ways in which value is being created now inherently require both more time and more capital throughout the hold period. It is not uncommon for a sponsor to reserve an amount equal to 50 percent or more of the purchase price as development capital.

According to Hamilton Lane data, nearly two-thirds of private equity assets are now taking longer than five years to exit. This extended value creation process has



implications for funds themselves. Platform companies acquired in year five of a fund's life may not be ready to exit until year 12 or beyond. Fund lives are generally extending well beyond the stated 10 years – frequently to 12 years and even to 14 or 15 years.

Managing larger reserves of undrawn capital well beyond the investment period of a fund's life also poses challenges for private equity managers. Portfolio companies can require even more capital than expected, depleting reserves and putting the firm's value creation playbook at risk.

### **Q So, what financing options do sponsors have when undrawn capital runs low?**

Until recently, the financing options available to funds low on uncalled capital were generally limited to LP co-investment at the fund level and holdco PIK financing at the individual portfolio company. These financing solutions have a number of disadvantages.

They deliver permanent or longer-term financing, when a short to medium-term solution is required. They provide funding at the cost of equity, when substantial unused debt capacity exists at the fund level. They require expensive prepayment premia, when debt – if it were available – would provide more reasonable redemption provisions.

We are now offering a bespoke solution, known as NAV Financing. Our capital is structured to match the duration of the financing need rather than being permanent, so it is inherently less expensive. When pricing our capital, we take into account the full equity value of the remaining portfolio of assets, so we offer a more efficient financing solution than has previously been available.

### **Q How is the US mid-market responding to this alternative?**

When GPs learn about what we at Investec Fund Finance have to offer, the response is often “I have a terrific use for that” or “I wish I had known about that two years ago when I was dealing with XYZ situation”. Generally, our clients are using NAV Financing one of three ways.

The first is to drive further value creation within portfolio companies through accretive M&A or injections of growth equity. The second is to protect a portfolio company experiencing a short-term setback and requiring equity to right-size its debt capi-

tal structure. And the third is to accelerate distributions to LPs where value has been created but not yet harvested.

### **Q How does NAV financing tie in with GP-led secondaries, another significant development for creating value later in a fund's life?**

We see NAV Financing as an important tool along a continuum of options that GPs have to help them drive value in the later stages of a fund's lifespan. GP-led secondaries are another of those tools and their use has exploded over the past few years. We think NAV Financing will as well.

Fundamentally, these GP-led secondaries provide new options for LPs in late-life funds. In a GP-led transaction, remaining portfolio companies are rolled into a continuation vehicle. New investors – typically secondary funds – bring fresh capital to drive further value creation in these portfolio companies.

The portfolio continues to be managed by a knowledgeable GP who is incentivised to build value over a finite further timeframe. Existing LPs can either roll their stakes into the continuation vehicle to participate in that potential upside creation or cash out. Investec Fund Finance has become a leader in providing efficient debt financ-

*“Until recently, the financing options available to funds low on uncalled capital were generally limited to LP co-investment at the fund level and holdco PIK financing at the individual portfolio company”*

ing to these continuation vehicles to help cost-effectively grow value.

### **Q How else is the industry innovating in response to this challenge?**

We are seeing increased interest from both GPs and LPs in evolving the limited partnership agreement to allow for longer duration investment activity. Probably the most common evolution we see in the LPA has been greater flexibility around recycling provisions, allowing early exits and cumulative fees and expenses to be rolled back into the fund for continued investment activity.

Longer investment periods are becoming less rare. We are seeing six-year investment periods a bit more frequently. There is a lot of talk about longer fund lives, as well. We are seeing funds raised with 12, 15 and even 20-year fund lives, although those maturities remain far from the norm.

### **Q What impact would a downturn have on both the demand for finance late in the life of a fund and its availability?**

Private equity's need to drive value doesn't stop in softer economic conditions. In fact, we know economic downturns can provide compelling opportunities to generate value for those with access to reasonably priced capital. But traditional financing sources often dry up then. So the challenge for private equity is to be creative in finding incremental capital to take full advantage of the opportunities that dislocations can provide.

### **Q What other opportunities excite you in the years ahead?**

Selling perpetual minority stakes in private equity firms is not new but is seeing accelerated activity. Investec's fund finance practice was launched more than 12 years ago, providing loans at the management company level. We are extending our longstanding GP expertise to provide efficient debt structures to support minority stake sales. We are also providing a range of GP financing alternatives to private equity managers who are really looking for a less expensive and intrusive alternative to the sale of a permanent stake. ■

Tom Glover previously held leadership positions in investment and corporate banking at BMO Capital Markets, Merrill Lynch, Deutsche Bank and Goldman Sachs. He is an employee of Investec USA Holdings Corp.

# The mid-market economy: Can strong growth continue?



Guest comment by **Thomas Stewart** and **Doug Farren**

*Mid-market companies have powered the US economy, but the National Center for the Middle Market sees concerns rising*

When we set out to study the US mid-market eight years ago, we knew it was important; it accounts for a third of private GDP, so it must be. What we didn't fully understand is that the 200,000 companies with revenues of \$10 million-\$1 billion that make up the mid-market are the most dynamic part of the US economy, too. They account for about 60 percent of job growth, they consistently deliver top-line growth that's higher than big or small companies, and they're resilient. They have survival rates comparable with big companies and a lot more runway for growth.

Just in the last 12 months, for example, mid-market company revenue grew on average 8.5 percent, compared with 2.2 percent for the companies in the S&P 500. That's a bigger than usual difference, but it's the kind of thing we see every quarter when we measure mid-market performance.

The employment picture is similar: 6.4 percent for mid-market, 1.0 percent for small business, and 2.3 percent for big business. We estimate that over the last eight years, mid-market companies have delivered about 60 percent of net new private sector jobs.

But this story is relatively little known. Partly that is because 85 percent of mid-market companies are private, so there are few stock market stories to tell. Big business titans and upstart entrepreneurs get all the news ink, while family businesses and private equity firms often stay below the radar, doing the work.

*“There is no bad time to buy good companies; capital is cheap; and some sellers may be more anxious than they should be”*

Private equity plays a substantial role in the mid-market. More than a quarter of the mid-market has PE ownership, and those companies do very well. According to our data, mid-sized companies in private equity portfolios grow about one-and-a-half or two percentage points faster than the mid-market as a whole and add jobs at a similarly higher rate. Indeed, private equity is itself a contributor to the dynamism of the mid-market.

Mid-market private equity investors tend to be more interested in sponsoring growth than in financial engineering. Private equity plays a role in many family business transitions, or it comes in to help a strong company scale faster than it otherwise would. Private equity isn't just present in the mid-market; it makes its presence felt.

## Signs of change

Will the mid-market continue to post these extraordinary gains in revenue and employment? Like everyone else, we have been poring over data trying to understand whether this long economic expansion will continue, flatten, or fade. Our *Middle Market Indicator*, which surveys 1,000 executives each quarter, gives us a unique view into what these leaders are seeing, saying and doing.

They see strong results, but also storm clouds. The revenue figures we cited above are near-record numbers. Only a handful of companies – about one in 20 – say business is deteriorating. On the downside, tariffs are hurting retailers, wholesalers and most manufacturers, and a small but growing

number say the business climate is deteriorating and demand is weakening. But overall, business is good.

They say they're going to be cautious. Mid-market executives are prudent, pay-as-you-go types even in the best of times, but their wariness is growing. Every quarter, we ask executives what they would do with an extra dollar: whether they would invest it or save it. In the last six months, the number who say they would put it by has jumped from 29 percent to 37 percent. Private equity-owned companies are even more savings oriented. They also say that their confidence in the economy, while strong, is not as strong as it was a year ago.

But what they do has not changed, not at this point. For example, in the last 12 months, 19 percent added a new plant or facility. Over the previous four quarters, that number was 17 percent, 21 percent, 20 percent and 20 percent. Looking forward, executives' expansion plans (to enter new markets, open new facilities, and introduce new products or services) are actually more aggressive than they were last year or the year before that.

### Looking ahead

What do these insights tell us about the economy? The physicist Niels Bohr joked: "It is very hard to predict, especially the future," but in the next quarter we'll be looking closely at three areas. The first is hiring.

As a rule, mid-market companies hire in response to growth rather than in anticipation of it. They always forecast fewer job increases than they make. A year ago, for example, they predicted a 4.8 percent increase in headcount, but delivered 6.4 percent. If companies start hewing to their forecasts and holding the line on hiring, that will be a sign that business is slowing down. The second is investment: Will the aggressive expansion plans stay in place? Or will leaders delay, diminish, or discontinue them?

The third number we will watch closely is the mix of winners and losers. In the last 12 months, 68 percent said overall performance improved, 26 percent said it was unchanged and 6 percent said it deteriorated. In the last two quarters, we've seen about a five-point shift from 'improved' to 'unchanged', but the 'deteriorated' number has stayed essentially the same. An increase

in that number would be worrisome. Partly cloudy or partly sunny, it's hard to know what the business forecast should be. That mixed message has implications for PE firms. First, don't let economic ambiguity tie your hands. Uncertainty paralyzes the unprepared, but it should energise the educated. There is no bad time to buy good companies; capital is cheap; and some sellers may be more anxious than they should be.

Second, an unsettled economic environment increases the value of the rigorous, data-driven management that the best PE firms bring to companies in their portfolios. We don't mean loading companies down with debt, rather, more hard-nosed working capital management and more emphasis on lean operations; all the blocking and tackling of good, efficiency-oriented management, will be even more valuable if the economy falters. In rough seas, you want a tight ship. ■

Thomas Stewart is the executive director of the National Center for the Middle Market.

Doug Farren is the managing director of the National Center for the Middle Market.

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## KEYNOTE INTERVIEW

# Where to set up offshore mid-market funds



*Popular offshore fund destinations are requiring more ‘substance’ and stiffer regulations. TMF Group’s **Anastasia Williams** discusses what this means for US mid-market GPs who have begun to hunt for deals and investors globally*

Private equity’s expansion means different things for different players. For managers in the US mid-market, it is driving asset prices skywards and keeping GPs on the fund-raising trail to make the most of the good times. According to Bain’s *Global Private Equity Report 2019*, mega-funds are frequently launching their own mid-market vehicles as diversification plays.

This leaves many US mid-market firms looking for investors and deal opportunities beyond their borders – and that requires utilising more, or different, fund structures. But private equity’s success has also prompted stricter regulation, and that means even friendly jurisdictions are demanding boots on the ground for locally domiciled vehicles. These jurisdictions still compete for funds, but have tightened regulations.

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According to Anastasia Williams, head of private equity, Americas at TMF Group, this requires more discipline and consideration from mid-market firms as to where they domicile funds. These GPs do not have the resources to staff up in three or four countries from scratch. And, given the trend towards more substance requirements and tighter rules in places like the Netherlands and the Cayman Islands, they cannot merely hop to another jurisdiction, because tighter regulations will eventually appear there too. Yet that does not mean there are no opportunities, as new jurisdictions, such as Ontario, are becoming competitive.

**Q If we take a broader view of the state of offshore fund destinations, what does the landscape look like to you at the moment?**

This trend towards more substance requirements and stiffer regulations hasn’t just appeared in the last year. For the last decade, regulators around the world have come to understand that private equity is an important asset class and one worth their attention. That doesn’t mean all the reforms are there to scold the industry. Many have been designed for greater clarity and consistency, even if that means less room for interpretation.

In some cases, things are better than expected. Brexit concerns haven’t eroded the appeal of domiciling funds in the Channel

Islands, despite concerns about what the UK's EU exit would mean for these neighbouring jurisdictions. So far, it's been business as usual.

Yet there's little doubt we're witnessing greater substance requirements for private equity firms that choose to structure funds abroad.

In the wake of the OECD's efforts to crack down on base erosion and profit shifting, jurisdictions around the world are working to balance the need to stay friendly to foreign managers with the need to meet new global standards of transparency and oversight. This project has led to some of the greatest changes in how managers are taxed in a generation.

We see the Netherlands as a bellwether territory. In 2018, it passed several new requirements for foreign investors, including employing a greater proportion of local staff, defined wages for those staff, and local office facilities that vastly exceed a simple mailbox.

The era of simply having an empty shell in some other country may be over. Now managers need people on the payroll. We expect it's only a matter of time before other jurisdictions, like Luxembourg, follow suit.

### **Q What's the state of play in Luxembourg? Are there any proposals in the works?**

Luxembourg is the biggest fund centre in Europe and the second biggest in the world, largely because of its high compliance standards, which are so appealing to LPs. This popularity isn't just among EU investors. A lot of US LPs like these regulated funds. But this also creates a burden for GPs.

Luxembourg offers a less regulated option called a reserved alternative investment fund. These grew from just 75 in 2016 to 325 in 2017, and reached a total of 575 in 2018. RAIFs are flexible, and provide private equity investors – whether they are GPs or LPs – with an excellent fund-structuring vehicle.

There is also a short time to market the RAIF, which is not subject to any authorisation or ongoing supervision by Luxembourg's financial regulator, the CSSF. However, the RAIF still needs to be managed by an EU AIFM.

GPs need to double-check that the RAIF makes sense. For example, if firms are looking for commitments from German institutional investors, the RAIF won't qualify

*“Middle-market firms will need to pick and choose a few jurisdictions that make the most sense for their likely LP base”*

because these LPs need to invest in a corporate structure. And precisely because they are less regulated than other fund structures, greater due diligence by LPs is required.

### **Q There have been some recent reforms in the Cayman Islands, a popular destination for fund structures. What do they mean for mid-market GPs?**

In June, the Cayman Islands passed the Securities Investment Business (Amendment) Law, which introduces a regulatory regime for 'excluded persons'.

These excluded persons used to be exempt from registering with the Cayman Islands Monetary Authority. This exemption was in place for those financial services firms catering to high-net-worth or sophisticated investors, who were expected to perform adequate due diligence.

This reform will now require most excluded persons to register and comply with greater reporting requirements. In essence, the amendment creates two new classes of excluded persons: those who will need to register with the CIMA, known as registered persons, and non-registerable people, who do not need to register or obtain licences but who will still need to submit to oversight by the authority for anti-money laundering purposes.

In addition, the amendment puts in place governance requirements for excluded persons. These include the appointment of at least two natural persons to the board

of directors, and the need for those natural persons to register as a corporate vehicle before conducting security investment business.

For middle-market firms, this means more time and cost in setting up structures, but it remains to be seen if these reforms will prompt GPs to look elsewhere. The Cayman Islands still offers a relatively friendly regime for US firms.

### **Q Are there any alternative jurisdictions that are becoming more attractive because of the global trend towards stricter regimes?**

We hear from fund attorneys and other market participants that Ontario is increasingly popular. There's a shared language and culture, and an understanding of how US private equity works, which might be a real asset for a middle-market firm reaching past its borders for the first time.

In light of stricter regulations, other factors, like culture, may matter more than they ever did.

In the coming years we expect a greater convergence of standards. With less and less difference among jurisdictions, managers may be less inclined to shop around for some ideal place, or to craft increasingly complex structures in pursuit of a particular tax benefit. That tax benefit might not be enough to warrant the complexity and the cost that inevitably comes with it.

Mega-funds will be able to deploy the resources, both in staff and outside expertise, to juggle structures in multiple jurisdictions. But middle-market firms will need to pick and choose a few jurisdictions that make the most sense for their likely LP base.

There was one firm that found a great deal of support in the UAE and ended up establishing a fund structure there for those key LPs.

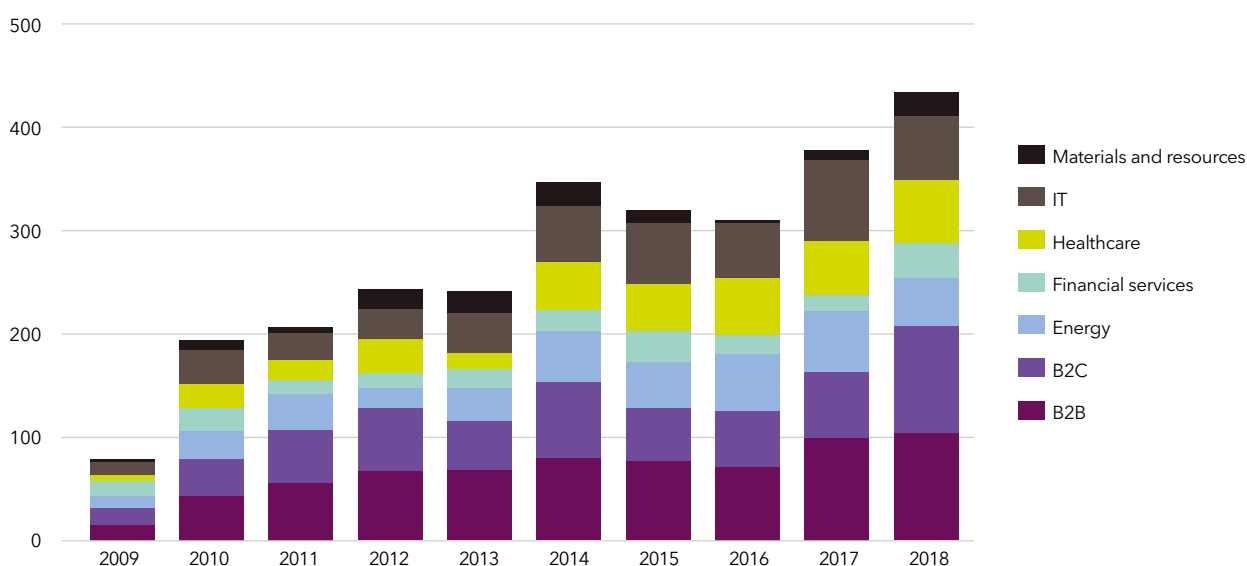
Just as middle-market firms are focusing on a particular sector to generate proprietary dealflow and expertise, they may need to focus on a few key jurisdictions that make the most sense for them, and their future. There may be little use in hopping to Poland for a few tax advantages that evaporate in a few years as that regime catches up with where the Netherlands is today.

It might be far better to commit to some jurisdictions that may be slightly stricter, but more reliable in the long term. Middle-market firms just don't have the luxury of globe-trotting indefinitely. ■

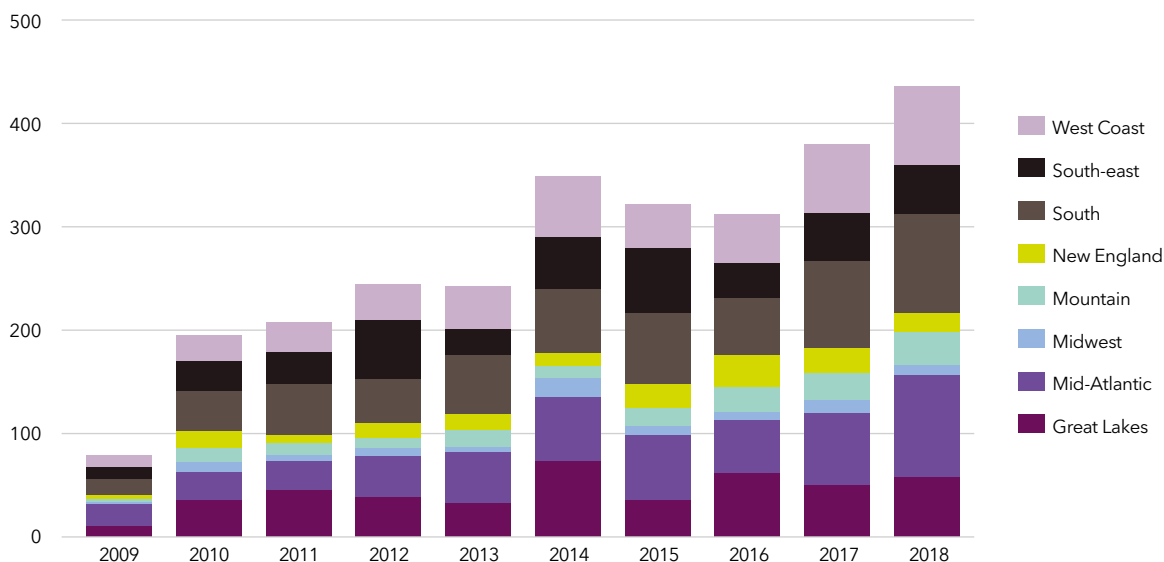
# Straight down the middle

*Mid-market revenue growth is strong and dealflow continues to rise – driven by the volume of B2B deals and value of B2C*

Dealflow by sector, B2C has rebounded strongly (\$bn)



Dealflow by region, the Mid-Atlantic accounted for the greatest share in the US for the first time since 2009 (\$bn)



Source: PitchBook



# 8.5%

Year-on-year mid-market revenue growth

# 41%

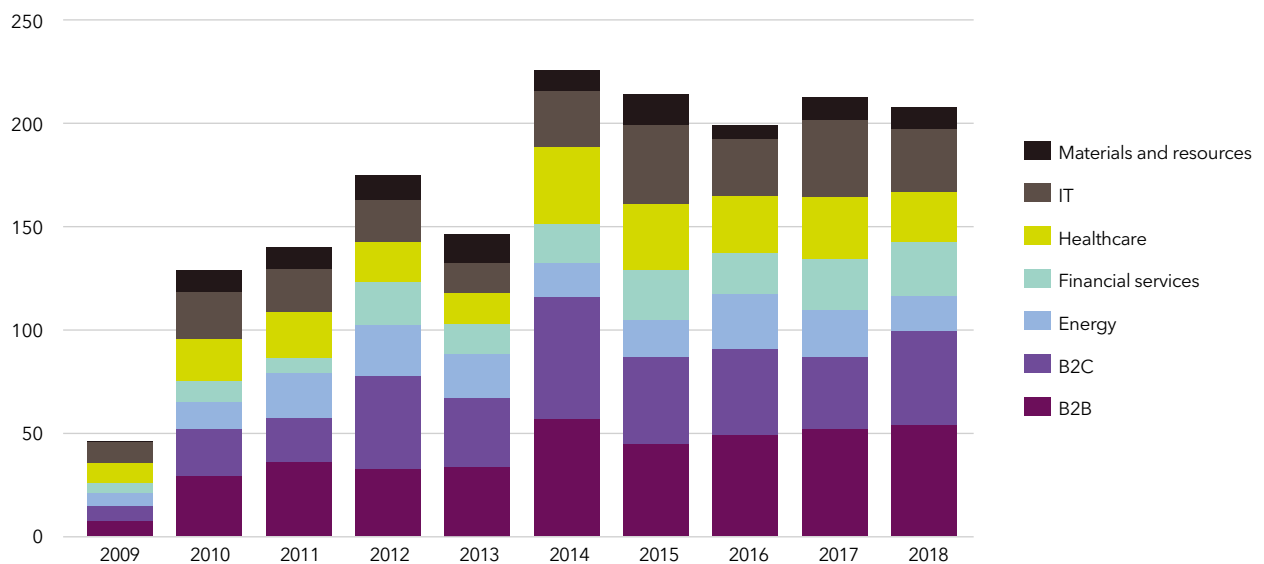
Proportion of mid-market companies expected to add jobs

# 69%

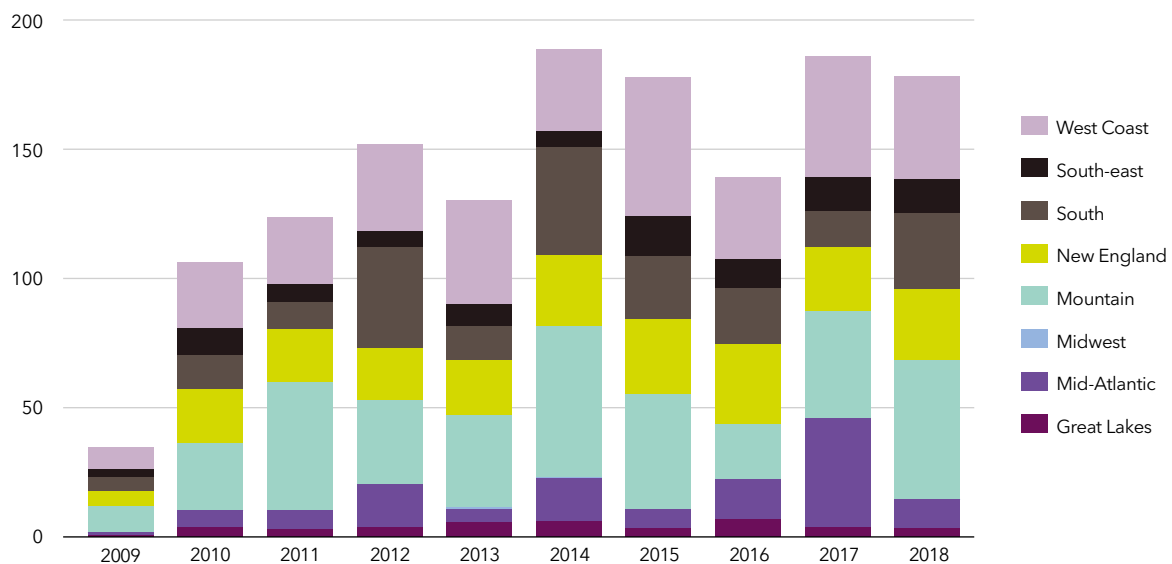
Proportion of mid-market managers have confidence in the global economy - the lowest level since end-2016

Source: 2Q 2019 Middle Market Indicator - National Center for the Middle Market

Exits by sector, B2B passed \$50bn for the third time since the financial crisis (\$bn)



Exits by region, Mountain region reaches the summit (\$bn)



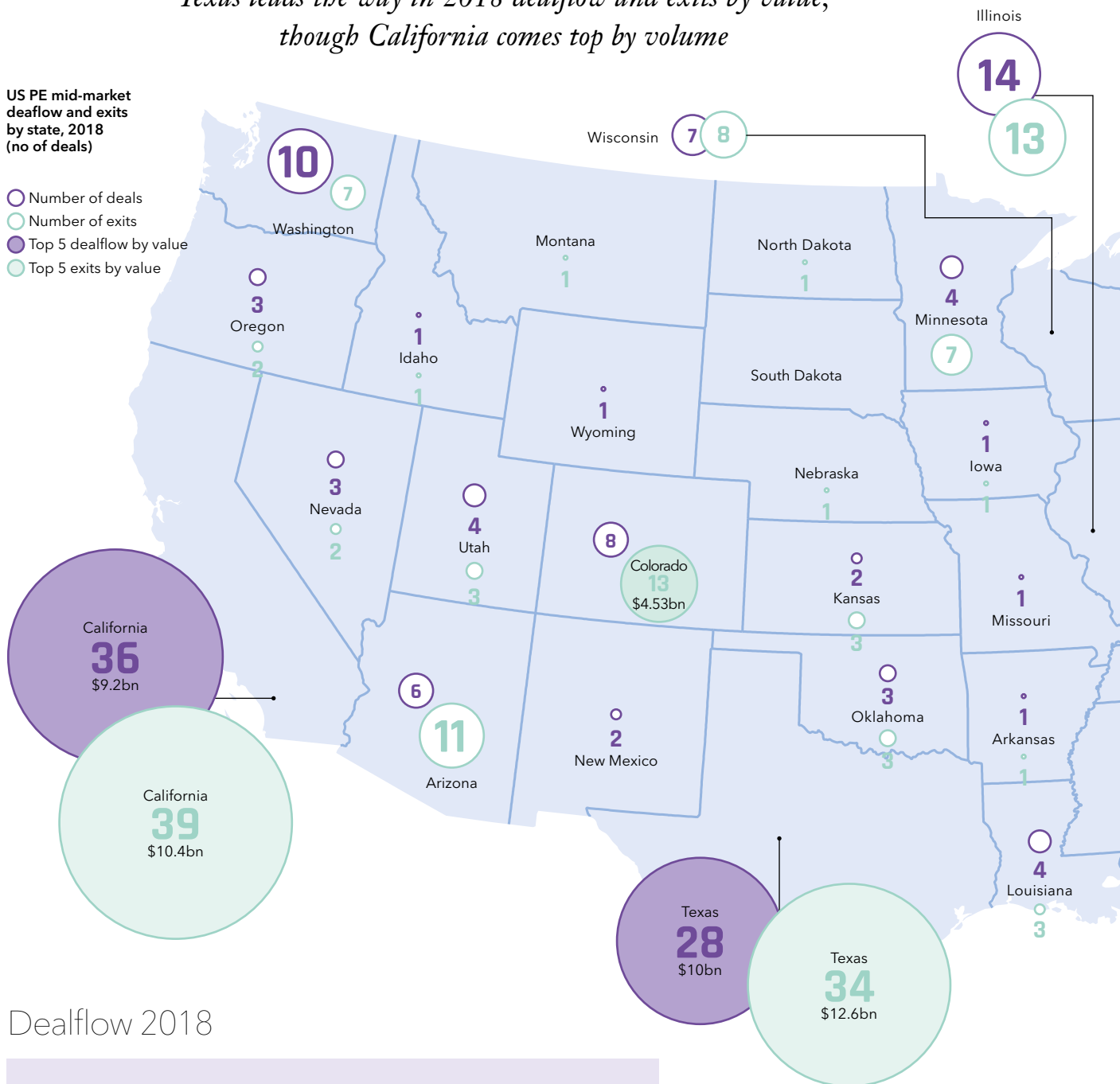
Source: PitchBook

# PE on the map

*Texas leads the way in 2018 dealflow and exits by value, though California comes top by volume*

US PE mid-market dealflow and exits by state, 2018 (no of deals)

- Number of deals
- Number of exits
- Top 5 dealflow by value
- Top 5 exits by value



Dealflow 2018

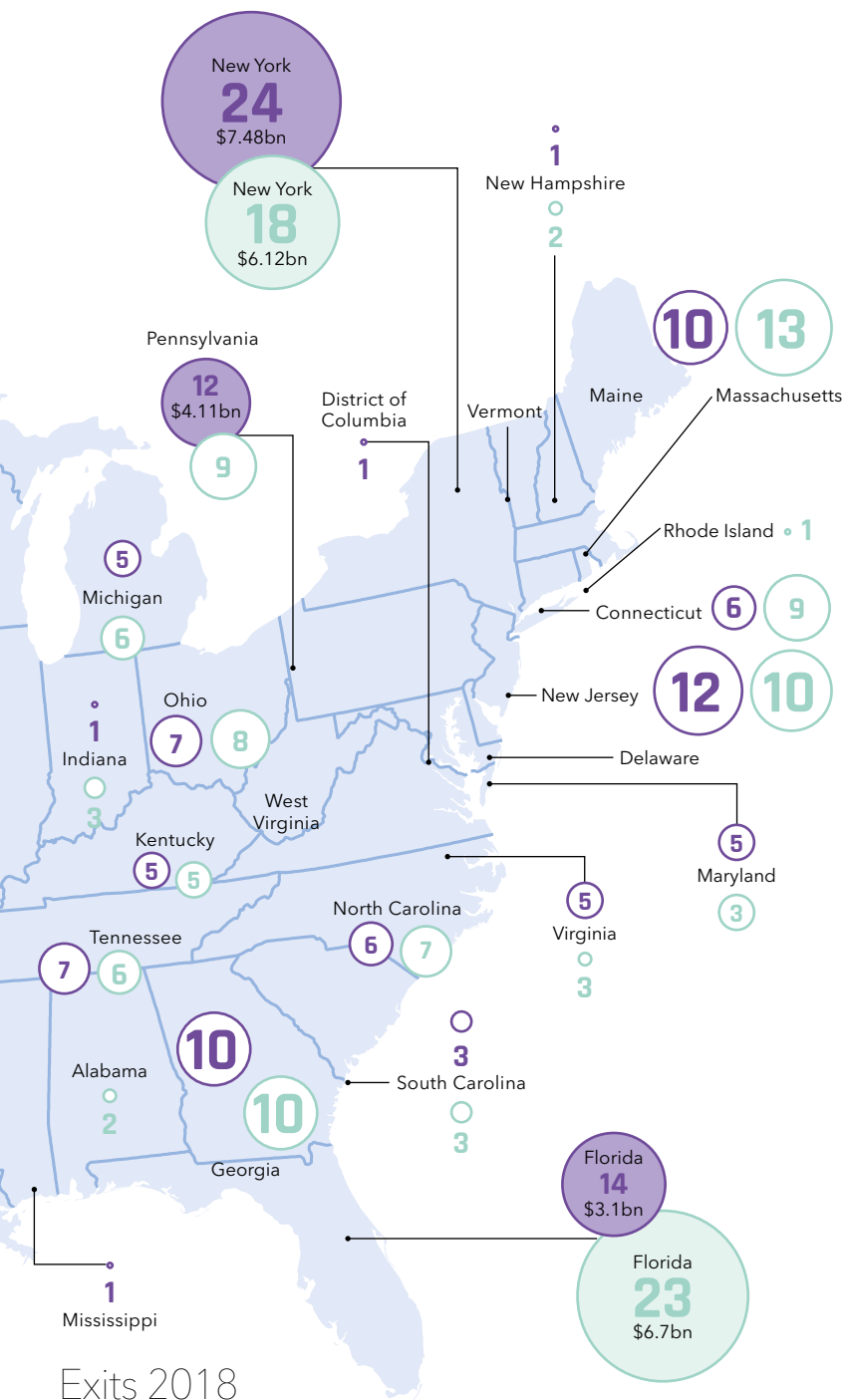
**\$438bn**

Total dealflow value

**3,072**

Total number of deals

Source: PitchBook. State-level figures do not include re-distributed values



**\$209bn**

Total exit value

**999**

Total number of exits

US PE mid-market dealflow and exits, by state, 2018 (\$bn)

State	Dealflow	Exits
Alabama	0.00	1.00
Alaska	0.00	0.00
Arizona	1.35	2.03
Arkansas	0.12	0.08
California	9.24	10.40
Colorado	2.07	4.53
Connecticut	1.54	2.18
Delaware	0.00	0.00
District of Columbia	0.63	0.00
Florida	3.09	6.65
Georgia	1.69	2.80
Guam	0.00	0.00
Hawaii	0.33	0.98
Idaho	0.11	0.34
Illinois	2.61	3.40
Indiana	0.06	1.38
Iowa	0.28	0.27
Kansas	0.84	0.94
Kentucky	2.37	1.72
Louisiana	0.38	0.65
Maine	0.00	0.00
Maryland	0.64	0.83
Massachusetts	1.22	3.37
Michigan	0.84	1.27
Minnesota	1.08	2.41
Mississippi	0.54	0.00
Missouri	0.40	0.00
Montana	0.00	0.05
Nebraska	0.00	0.08
Nevada	0.70	0.87
New Hampshire	0.18	0.21
New Jersey	2.98	2.12
New Mexico	0.22	0.00
New York	7.48	6.12
North Carolina	1.97	2.57
North Dakota	0.00	0.19
Ohio	2.29	3.62
Oklahoma	1.32	0.81
Oregon	0.74	0.19
Other US Territory	0.00	0.00
Pennsylvania	4.11	3.40
Puerto Rico	0.70	0.00
Rhode Island	0.00	0.51
South Carolina	0.46	1.69
South Dakota	0.00	0.00
Tennessee	1.86	1.60
Texas	10.01	12.57
Utah	0.90	1.36
Vermont	0.00	0.00
Virgin Islands	0.00	0.00
Virginia	0.58	1.19
Washington	2.54	2.78
West Virginia	0.00	0.00
Wisconsin	2.74	3.83
Wyoming	0.10	0.00



## Q&A

*Paul Carbone, president and managing partner of Pritzker Private Capital, on life since his firm's split from its parent group*



Pritzker Private Capital, which invests on behalf of the Pritzker family among others, separated from Pritzker Group Private Capital in February last year. Led by president and chief executive Tony Pritzker and president and managing partner Paul Carbone, PPC raised a committed capital pool of \$1.8 billion in 2018. It invests in North American mid-market companies, focusing on manufacturing, services and healthcare.

### Q What has surprised you this year?

A The pricing in the markets – I just didn't think we would be here. Valuations continue to be very high and we didn't foresee this when we were thinking about 2019, because everyone was talking about the economy and potential slowdown.

That said, we are in no hurry to make investments. This year we acquired Valicor and intend to acquire another one or two; but even if we don't, we are not concerned.

### Q Why did PPC separate from the Pritzker Group?

A The decision to separate was driven by several considerations. For one, while we were building great companies and writing meaningful cheques to those companies, our money was staying in the ground longer. We didn't think it was prudent from a risk and diversification view to continue with that strategy, even if the Pritzker brothers are enormously wealthy.

At the same time, we had other family offices that wanted to partner with us. For one deal that required substantial investment, we invited capital from other families, but the

process proved to be very cumbersome, and we realised we needed to move with more certainty and speed. We decided to form a club with select other families and raise a committed capital pool for co-investments. The Pritzkers are the largest investors in the pool, and we retain complete discretion over the investments.

### Q What changed after the split?

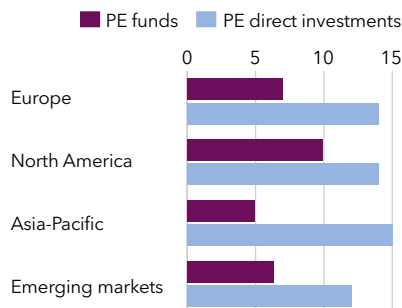
A Everything at PPC remained the same. The same team, the same ideology and approach of investing in and growing our companies. We are still investing in family, entrepreneur or management-owned mid-market businesses that care about their business post-close, and care about their legacy and employees.

We often say we are the third option versus private equity firms and strategic investors. We are a family pedigreed firm with longer duration capital and are very cognisant of legacy, an issue that is close to the kind of companies we want to partner with.

Up until now we took majority positions in the companies we acquired. Now we have expanded our investment criteria to take substantial minority positions as well.

This came [about] because we have been in discussions with family businesses that are looking for capital and partners but are unsure about what they want. Do they want to sell minority or majority positions? How do they want to structure partnerships? Expanding our criteria allows us to initiate legitimate dialogue on their needs and how we can help execute their strategies. ■

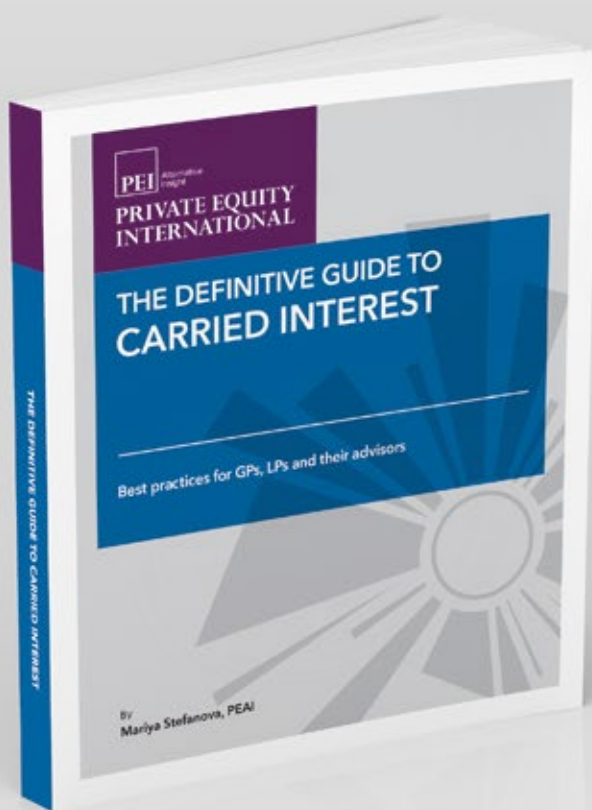
Almost a quarter of the average family office portfolio consists of private equity funds and direct investments (%)



Source: UBS/Campden Wealth's 2018 Research Global Family Office Report

*"We often say we are the third option versus private equity firms and strategic investors"*

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