Market Insights

Hop aboard the US growth engine

Mid-market private companies have the potential to expand rapidly while avoiding high exposure to volatile public markets. Benoit Jacquin and Nitin Gupta, of Caspian Private Equity, explain how to invest in them

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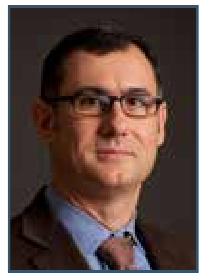

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Are investors being too defeatist? From investment conferences to pension scheme boardrooms, the prevailing opinion is that meeting investment objectives is becoming more and more elusive. Even after the equity market downturn in Q3 2015, few investors see clear value in public markets. And with bond markets still historically expensive, many investors feel they have nowhere left to turn.

This is to ignore alternatives, which can tap sources of return not available from public markets. Growing numbers of institutional investors allocate to alternatives, albeit in small proportions compared with their allocations to traditional equities and bonds. Old habits die hard, it seems.

Alternative funds can employ esoteric assets such as timber and art, while others have developed sophisticated strategies which use powerful computers to profit from discrepancies in the prices of assets traded on public markets. However, alternative strategies don't have to be esoteric or complicated. Some can be found right under our noses and are straightforward to understand. Take US private companies. There are some 6m private companies in the US – many employ just a few people, and some are vast (think Dell, Cargill and PwC). A great swathe in the middle, however, are not one or the other – and these companies are the engine of corporate US, driving the economy and providing the lion's share of jobs. Those in awe of the power and resilience of the US economy are, in reality, admirers of the "mid-market" private sector.

Grabbing on to the coattails of the fast-growing, ambitious companies that comprise this sector has long been a strong source of return for investors.

Accessing the mid-market

The trouble is, many mid-market companies are not listed on public markets, sometimes because they are too small to gain a listing, sometimes because they operate in niche markets not well understood by equity investors or simply because of regulatory burdens. And those that have listed have been well prepared for IPO and may have already maximised growth and minimised costs, leaving less value for stock market investors. Exposure to high-growth mid-market companies is possible, however, through private equity investments.

The mid-market is commonly defined as companies worth between \$500m and \$1bn. The lower mid-market – companies worth \$50m-\$500m – can also be attractive, with growth rates often higher and funding needs lower. In addition, because smaller companies operate in (and preferably dominate) niche markets, they are potentially less susceptible to economic and market volatility. For all these reasons, Caspian's current co-investment fund has chosen to primarily focus in the lower mid-market private equity space.

Investors vote with their capital

The US middle market is proving increasingly attractive to investors from all corners of the globe. An influential survey this year revealed that institutional investors worldwide ranked mid-market buyouts as their top private equity investment target. Asian respondents to the survey – many of whom prefer to invest in domestic assets –ranked the US mid-market third out of 26 private equity sub-sectors. Investors in the survey signalled that they prefer the mid-market because they believe too much money is heading for the large buyout space.

As a result of the mid-market's popularity, middle market funds are growing rapidly. The average mid-market buyout fund size grew from $697m in 2013 to $797m in 2014 . Fundraising is particularly strong in the lower-to-core mid-markets - 32% of mid-market funds closed in the $100m-$250m range.

Why co-investments?

Sourcing and executing lower mid-market deals takes time, expertise and resources. There is often little publicly-available information on target companies and management data can be less comprehensive than at larger companies. Value is primarily derived from unearthing and then developing the intrinsic qualities of the target companies, rather than from leverage and refinancing. The private equity house needs to get very close to the company, carry out intense due diligence and remain close to the company throughout its time in the portfolio.

As well as gaining deep, fundamental knowledge of companies, it is important for the mid-market investor to build a diversified portfolio in order to mitigate risk. For this reason, we usually co-invest alongside a lead sponsor. This enables us to spread a fund of, say, $200m-$300m across 20-plus investments and achieve meaningful sectoral diversification. This compares with portfolios of usually six to eight companies among some lead lower mid-market sponsors.

The due diligence process in the lower mid-market sector is helped by the fact that the sector is less crowded than the large buyout space, and that there are fewer co-investors. Being the sole co-investor, or one of a small number, can offer more frequent access to the target company's management. This is often not possible in deals with a large number of co-investors.

Sourcing deals

Co-investments are growing. Since 2009, a fifth of all private equity buyouts have involved co-investments. With 895 middle market private transactions in the first half of 2015 alone, (according to Pitchbook, a private equity research firm), worth a total of $159bn, there are a great many co-investment opportunities.

The key to finding the best deals is to keep many different channels open. For Caspian, this means making fund investments as a limited partner, as well as co-investing. This keeps us in regular contact with general partners and can gain us access to co-investments later on. In addition, all our principals have strong professional networks. Finally, our parent company, Natixis, has a leveraged finance group which also gives us access to dealflow.

Although demand is growing for lower mid-market deals, it is still low compared to the large buyout universe. And while appetite has increased for co-investments, there are few dedicated vehicles. So we often find we are able to pick and choose the best deals in the market.

Where is the action?

Deal activity has been broad across our two funds to date. Exits from our portfolios include Dynacast (a provider of small part die casting), Essent (a provider of private mortgage insurance), Sterling Background services (a provider of pre-employment background screening services), Accelecare (a provider of wound-care centers within hospitals) and La Colombe (a retailer of specialty coffee).

Of course, without a viable exit, no private equity investment can return money to investors. One of the benefits of lower mid-market investing is the breadth of exit opportunities. Whereas for large buyout deals the main exit option is the IPO, in the lower mid-market, trade sales and secondary deals are equally possible. Their smaller size makes them attractive acquisitions for many parties. For this reason, Caspian's holding period is usually shorter than the average for the private equity industry, and so investors are able to recycle their returns more rapidly.

Return expectations

As co-investors, we have pari-passu rights as the lead investors in the deal. Unlike the lead investor, we have no board control over the portfolio companies, but the other terms of the deal – including price and our legal protection – are generally similar to the lead sponsors. In addition, the fees charged by the Caspian funds are generally lower than a comparable lower middle market fund. So overall, Caspian's investors get the exposure with greater overall diversification and reduced fees.

Currently, the net return expectations for our co-investment funds, expressed in net IRR, are 15%-20%. This reflects the ROI levels at which the deals are underwritten by the funds, and the expected holding periods. Of course, these expectations may vary with market conditions. Expected holding periods are around five years – although many of our exits are faster than this – and lock-up periods are generally 10 years, in line with the broader private equity sector.

Alpha for all

So what kind of investor does mid-market private equity co-investment suit? With Caspian's deals typically in the $5m-$35m range, ticket sizes are small compared to most private equity funds. This should suit all institutional investors looking for access to US lower mid-market alpha.

"Private Equity Institutional Investor Trends for 2015" – Probitas Partners
"2015 Annual US Middle Market Report" - PitchBook

ADDITIONAL NOTES

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