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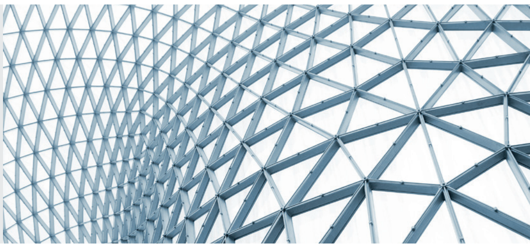

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Private equity: the lure of local

Smaller, localised deals may outperform in a deglobalizing economy

Key Takeaways:

- Amid a shift towards deglobalization and localisation, localised private equity strategies have substantial potential for outperformance. France is a mature but still growing private equity market and has huge opportunities in the €5m to €100m space.
- Smaller companies can be improved more easily than their larger counterparts. Alliance Entreprendre aims to double revenues at portfolio companies over five years either organically or, more often, through bolt-on acquisitions.
- Alliance Entreprendre's partnership with Caisse d'Epargne gives it unparalleled access to smaller companies across France that are seeking growth financing. Many of these companies are ready for LBO financing, one of the highest-performing private equity sectors of recent years.

The principle of global diversification is well accepted by private equity investors, and many now have some international exposure.

But the notion of diversification – the spreading of risk across strategies and assets – is subject to change as markets evolve. And markets have evolved markedly in recent years.

One major change is the tangible shift towards deglobalization and localisation, driven by political expediency. In this scenario, localised private equity strategies have substantial potential for growth and outperformance.

Olivier Boré
CEO
Alliance Entreprendre

Nathanael Martin
Managing Director
Alliance Entreprendre

Small caps are a fertile hunting ground

Local tends to mean smaller. And small can be a profitable place for private equity investors.

"There are many reasons to invest in the small- and mid-market private equity sector, and the current political changes and public health issues actually increase the sector's attractiveness," says Olivier Boré, chief executive of Alliance Entreprendre, an affiliate of Natixis Investment Managers.

Many smaller companies have been long-owned by their founders, who are ready to hand over to professional managers through private equity deals. And while there is a huge number of companies ready to make this transition, there is relatively little competition to buy them. Boré notes: "This is an unstructured market. It is not simple to find deals and execute them. We have been in business since 1995, so this works to our advantage."

Boré notes that France, the hunting ground for most of his firm's transactions, is the largest private equity market in continental Europe and similar in size to the UK. "France is still a growing private equity market and has huge opportunities in the €5m to €100m space," he notes. "There are tens of thousands of smaller companies we can invest in."

Due to their lack of size, scale and, sometimes, professionalism there tends to be greater scope for strengthening smaller companies after acquisition. Strengthening measures include better financial controls and access to finance, changes in management personnel and structure, improved governance, digital transition and ESG awareness.

It is also easier to make bolt-on acquisitions in a market which is ripe for consolidation due to its owner-manager structure. "We do a lot of bolt-ons with our portfolio companies," says Nathanael Martin, managing director of Alliance Entreprendre. "We mainly build up our companies in France, but also across the EU bloc where deglobalisation is not an issue."

The primary aim is to double revenues at portfolio companies over the average five-year holding period. It is not always possible to do this organically so growth can be sped up through acquisition. The addition of other companies is done strategically to create a national or regional champion, to move into new areas or new sectors.

The secret to sourcing small deals

In the mainstream private equity market, where deals are counted in the hundreds of millions or billions of euros, there is a small army of brokers and middlemen helping to oil the deal machinery. There is no such machinery for smaller-sized private equity deals, where sourcing is more manual.

Gaining access to smaller private equity markets requires know-how, experience, partners, networks and teams. "We have focused on the SME sector for 25 years and all our investment professionals have wide and diffuse networks," says Martin.

As well as these informal networks, Alliance Entreprendre has a formalised partnership with Caisse d'Epargne, the 200-year-old French banking group which has 4,700 local branches. In return for investment training and financial services, Caisse d'Epargne allows Alliance Entreprendre unparalleled access to smaller companies across France that are seeking growth financing.

"The relationship is beneficial for all parties," says Martin. "We work with Caisse d'Epargne to help build their clients' businesses, while we get access to some proprietary opportunities every year. Added with the opportunities generated by the teams' network, it represents ca. 300 opportunities a year, which gives us a very strong position in the smaller private equity market in France."

It's all about the people

Assessing management is a key success indicator when investing in any company, but for smaller companies the quality and capabilities of management are critical.

The starting point for assessing management is discussions with the founders, an examination of their track record and assessment of data which backs up this record. "Our investments take account of the figures produced by a company, but mainly we are investing in people and that is what we look at most closely," says Martin.

This means spending substantial time with founders and senior managers to assess their ideas for the future and how they plan to execute on their ideas. Alliance Entreprendre also wants to know how reporting lines are managed, the managers' understanding of ESG issues and their knowledge of the company's markets.

This human aspect of due diligence also aims to uncover whether there is alignment between the founders and Alliance Entreprendre as the new majority shareholder. "One of our key strategies is to foster growth by bolt-ons," says Martin. "We need to know whether management is aligned with that and whether they have the skills to do it."

The key small-cap strategies: LBOs, co-investment, and venture

The main strategies for investing in smaller companies are majority leveraged buyouts, minority investments (be it buyouts or growth capital) and venture investments. "We organise our firm as a platform with three different teams making investments in these three segments," says Boré,

The leverage buyout (LBO) team looks for deals where Alliance Entreprendre can be the lead investor and therefore able to control the leverage in deals, the price paid, and the ongoing strategy for the company. "The lead investment role suits us because we have experience of both small cap investment and LBOs, so we are able to enhance performance," says Boré. He notes that LBOs of small-cap companies are one of the highest-performing private equity sectors of recent years .[1]

Minority, or co-investment stakes, tend to range between 20% and 50%. While Alliance Entreprendre has less influence over company direction, the advantage of this structure is it can invest in larger companies when a suitable opportunity arises.

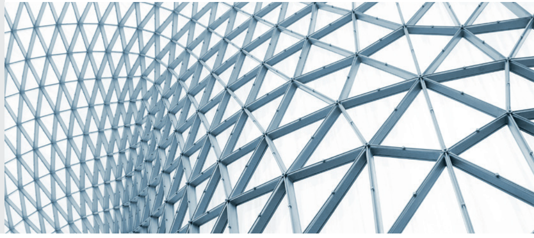
Venture investments tend to be small allocations to young companies, typically in the digital, cloud, cyber security and media sectors. "Considerable technical expertise is needed to understand what drives the business models of these kinds of start-ups," Boré adds.

Can small caps survive post-pandemic environment?

The consequences of the health pandemic are likely to endure for many years. Alliance Entreprendre believes the impact on the small-cap private equity sector will be mitigated by the measures taken in the Great Financial Crisis during which companies learned to cope with adversity, including reining in costs. In the aftermath of the GFC, many companies prepared for future turbulence by restructuring debt and rebalancing revenues to more sustainable activities.

"There is great discipline this time around," says Boré. "Companies in our portfolios are not wondering how to make the next bank interest payment." Most companies in the Alliance Entreprendre portfolios are B-B rather than B-C, which means their revenues are not dependent on cyclical consumer demand.

1. Source: France Invest/EY - Private Equity Performance Survey 2020.



As well as experience of the last crisis, companies have also benefited from generous state support from countries in the developed world, with France applying particularly generous measures.

And for investors thinking of increasing allocations to small-cap private equity, the pandemic is likely to throw up many opportunities where poorly-managed companies become distressed or forced sellers and can be bought at attractive prices.

Small is beautiful

It can be seen that investment performance in private equity need not depend on the acquisition and divestment of large multinationals with global operations. There is a wealth of small companies which can grow and prosper in a localised business environment, providing substantial returns to investors.

Investing in smaller, local-focused companies represents a change in mindset from the notion that diversification is improved by broadening the geographical asset mix. Yes, a longer geographical reach can be a useful diversifier. But localised strategies that will not be impacted if the world becomes less connected can provide a robust hedge against deglobalisation.

Small really can be beautiful.

Written in January 2021

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