FONDINVEST CAPITAL – 10 YEARS OF INVESTING WITH SME MANAGERS

# Why small is still beautiful

*Private equity as a whole has changed dramatically over the last decade – but in the European small and mid-market segment, it's been a question of evolution rather than revolution. That's no bad thing, according to Fondinvest Capital's Charles Soulignac and Catherine Lewis*

> "For every year between 1997 and 2011, except for 2001, the cumulative returns of small to mid-market buyouts have been around 25% higher than for large buyouts"

The European small and mid-market private equity industry is not exactly where it was 10 years ago, but it's not a million miles away. While, at the larger end, much of the decade has been spent chasing ever larger deals, this part of the market has been expanding more in terms of GP numbers than amounts invested.

The phrase JAMBOG (just another mid-market buyout group) may have been spawned over the last few years as a reflection of the ever-growing number of funds that have appeared in this space. But there are plenty of firms that have matured during that period, developing specialist areas of expertise in response to increased competition. The upshot is that investors now have much more choice about where to invest their capital now than they did a decade ago. "The landscape of GPs has really grown in this part of the market over the last 10 years," says Catherine Lewis, partner at Fondinvest Capital. "As a result, there are now different GP offerings targeting different types of investors."

Much of the change in the mid-market has been about providing more support and advice to portfolio companies, in addition to capital. The trend towards hiring operating partners may have started at the larger end of the market, but these days, it's just as common to see experienced industrialists retained (rather than hired) by mid-market GPs.

One of the most tangible signs of this is in the increased international outlook of many of these firms. As globalisation has gathered pace over the last decade, it's not just multinationals that have needed a presence in many different countries. SMEs have also needed to look abroad to remain competitive. The crisis has simply accelerated this trend. "GPs are increasingly looking at diversification strategies for portfolio companies – especially expansion into emerging markets," says Lewis. "They have been trying to work out the different ways of growing businesses at a time when European GDP growth will be flat."

Some firms have developed contacts in new markets to help portfolio companies expand, while others have whole teams dedicated to this. LDC, for example, opened an office in Hong Kong a few years ago – not to make investments, but to facilitate expansion into the market. Baird Capital Partners Europe has 15 people in Asia in addition to the firm's investment team – whose sole job is to help portfolio companies procure, outsource and tap demand in the region's emerging markets.

The mid-market was already becoming more hands-on, but the impact of the crisis caused many managers to sharpen their value-adding tools. "GPs now need to bring more to portfolio companies than previously," says Charles Soulignac, managing partner at Fondinvest. "They need to understand in-depth how companies work – previously they might have known businesses only through the investment company, but now they have to be more hands-on. We saw this in the crisis and it really separated the high-quality GPs from the rest. Some were able to help very efficiently; others couldn't, because they didn't know how."

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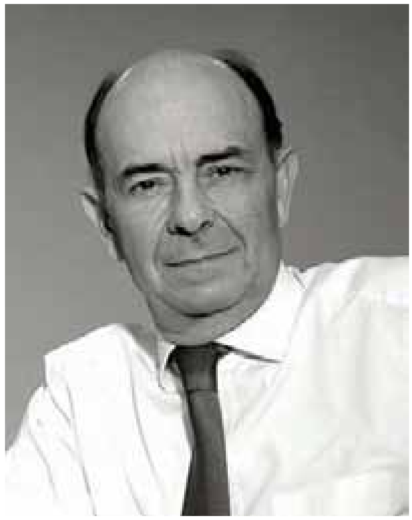
**Lewis:** *Undermanaged SMEs are ripe for GPs to add value*



**Soulignac:** *European SMEs must look for international growth*

Indeed, of all the events of the last 10 years, the crisis is possibly the only one that has had a lasting impact on this part of the market. While debt was far less of an issue here than at the larger end, negotiating with banks when companies faced difficulties was a challenge for some.

"Companies suddenly went from being cash positive to being cash negative," says Soulignac. "This was a problem for some GPs and managers who simply didn't know how to deal with this. They also found it hard to deal with the banks; rather than making money for them, they were asking them for support. That's a tough turnaround, and not all GPs and managers got that right."We've already started to see some mid-market GPs struggling as a result.

However, the small and mid-market remains attractive, say Lewis and Soulignac, who argue that returns in this part of the market have been particularly good. "For every year between 1997 and 2011, except for 2001, the cumulative returns of small to mid-market buyouts, on a weighted average IRR basis, have been around 25 percent higher than for large buyouts," says Soulignac.

The reasons for this are to do with the fundamentals of this part of the market – which are not going to change. "Competition in this segment tends to be lower; the opportunity for performance improvement tends to be higher because these businesses are family- or privately-owned; and build-up opportunities are great," says Soulignac. "If you commit to a good GP who in turn backs a good management team, there is a lot of scope to increase the value of the company."

He adds: "There is also still scope for multiple arbitrage at this end of the market – a small business might be acquired for 5x EBIT, while one that has built up scale can fetch 7x EBIT." As always, the potential for professionalising companies in this part of the market provides upside for hands-on investors.

"Multiple arbitrage is easier at this end of the market, but it's also the case that these companies tend to be undermanaged," says Lewis. "Private equity has the opportunity to add value by putting systems and procedures in place as well as through 'buy and build' strategies – and the value added is clearly reflected in the exit multiple."

While this part of the market has undoubtedly become more competitive, and investment strategies more hands-on, there is much about it that remains the same. "The basics of investing in this part of the market have not changed over the last 10 years," says Lewis. "It has always been, and still is, a market where GPs have focused on business building. It is about finding an opportunity, not paying too much for it, working with the management to create value and finding good buyers."