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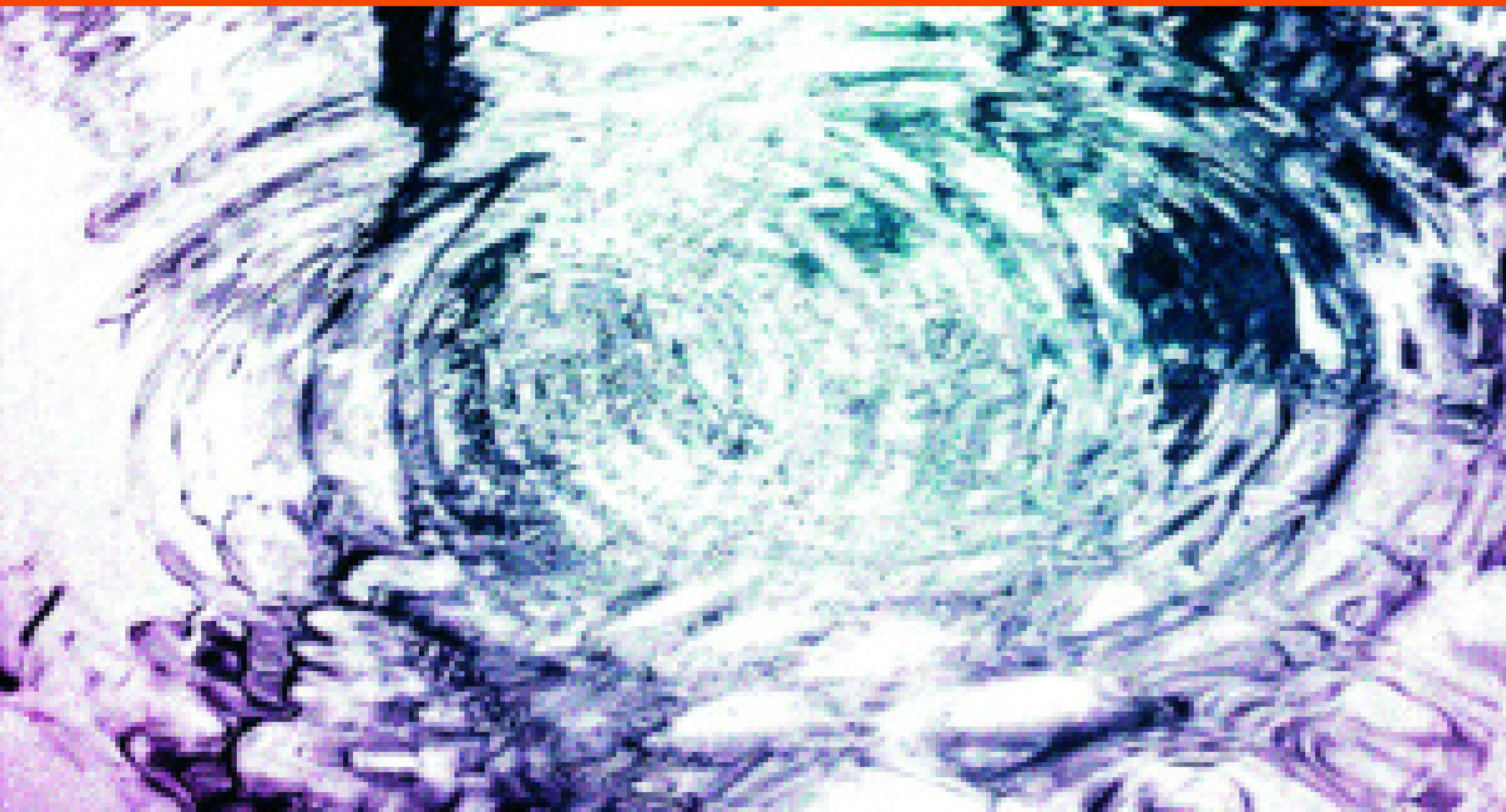
BVCA investing in enterprise

Understanding the UK Mid-market

October 2003



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Acknowledgements

AltAssets and the BVCA would like to express their thanks to all the general partners and limited partners that took part in the survey.

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ISBN 1-904620-14-0

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1. EXECUTIVE SUMMARY

The UK mid-market has been one of the most important breeding grounds for today's European private equity industry. The sector's lengthy history, however, has not been a limiting force and it has undergone its own dramatic changes in recent years. The effect has been the emergence of a clearly stratified marketplace with a sophisticated infrastructure. It is judged to have a larger population of high quality and experienced teams than anywhere else in Europe. And it is viewed as enjoying a steady supply of deal flow and a more supportive operating environment than the other regional markets. This maturity and dependability are considered the pre-eminent virtues of the UK mid-market, particularly during a period of financial and economic uncertainty. It has been spared most of the excesses of the late 1990s, leaving it well positioned to benefit from a gradual improvement in conditions.

Some 80 per cent of limited partners say the overall quality of teams in the UK mid-market is higher than in continental Europe but they say that the best of the continental teams are now easily a match for the UK's best.

A balance of 53 per cent of institutions also said that in their experience overall returns from the UK mid-market had been higher than from continental Europe. The quality of deal flow and the exit environment were judged to be marginally higher in the UK. And limited partners (LPs) firmly agreed with general partners (GPs) that the operating environment in the UK was more supportive for private equity than in many parts of continental Europe. LPs and GPs ascribed most of the UK's advantage to its greater maturity as a private equity market. Despite their emphatic endorsement for the UK, both LPs and GPs said that the gap between the UK and continental Europe had narrowed considerably in recent years.

Analysis based on the ratio of completed deals to the number of firms suggests the UK mid-market is less competitive than continental Europe even if LPs and GPs often think it is more competitive.

The view of LPs and GPs is generally based on the number of firms that are active in the UK compared with the number in the individual continental mid-markets without any adjustment for the volume of deal flow. Despite this perception, however, the UK enjoys the highest ratio of deals to buy-out firms in Europe. In other words, although there are more firms in the UK than almost any other individual market, there are also a lot more deals to share around those firms.

There are approximately 50 firms active in the UK mid-market, completing nearly 180 buy-out and buy-in deals in 2002. That produced a ratio of almost four deals per firm. The average in France is just below three, in Scandinavia a little above two and in Italy it is only one. Roughly half of GPs said the UK mid-market had become more competitive over the last five years and about 20 per cent said it had actually become less so. About a third of LPs thought it had become more competitive over the same period.

Some 80 per cent of GPs are positive about secondary buy-outs and say they have become an established exit channel; LPs are less enthusiastic.

A large majority of GPs said the recent growth in secondary buy-outs was not simply a cyclical phenomenon and that they would remain an important feature of the mid-market even when broader exit conditions improved. They said secondaries were a reflection of greater segmentation in the industry, with smaller buy-out firms passing assets up to the larger players as they grew. Only 20 per cent of LPs said they thought secondary buy-outs were a good thing, 27 per cent said they were bad, and 53 per cent said they were uncertain or undecided. The main concern was that secondary buy-outs would generate weaker returns than sales to strategic buyers.

Sector specialisation has become increasingly common throughout the UK mid-market, with nearly two-thirds of firms saying they have an explicit sector specific focus, but LPs are so far undecided about its merits.

The most popular sectors are consumer, business services, media, leisure, and healthcare. GPs say the main benefits of an explicit focus are in refining a steady stream of quality deal flow and in being able to make informed decisions quickly about investment opportunities. Most of them say it is designed as a means of marketing themselves to intermediaries and the other main sources of deals. LPs are generally ambivalent towards sector specialism. A third say they do not like sector specialism because it compromises the diversification of a portfolio. But just over a quarter say they like it because it improves the quality of deal flow and helps build industry relationships that benefit exit strategy.

GPs and LPs alike expect the segmentation in the UK mid-market to become increasingly clear over the next few years with the effect of there being a distinct upper and a lower segment.

There are a growing number of firms that are already only active in either the upper or the lower end of the mid-market. The main forces for this change have been the big increase in the size of funds that have been raised, a growing professionalisation among all the parties involved in the mid-market, and broader financial market conditions. Also important have been a shift from volume investing to a more selective approach among most participants and the withdrawal of some influential and longstanding players, albeit possibly only temporarily. Looking ahead, there is more concern about crowding in the upper end of the market, where there is a risk of competition from large buy-out firms moving back down the scale.

2. DEFINING THE UK MID-MARKET

▲ The term mid-market has expanded in meaning in recent years.

Any analysis of the UK mid-market needs to start with a definition but it is at this earliest stage that the endeavour meets its most significant obstacle. The UK mid-market is a dynamic and fluid construct. It has changed considerably since its nascence in the early 1980s, particularly in the last few years. Some of that change has been the result of a natural process of the market maturing, and some of it has been affected by broader developments in financial markets. But the definitional problem has also been compounded by some recent linguistic opportunism. A lot of private equity firms, recognising shifts in investor appetite and a lower tolerance for perceived risk, have enthusiastically employed the term mid-market in the hope of more neatly meeting these preconceptions.

The effect of this change has been the cause of some mild confusion and frustration among GPs and LPs alike. Sometimes this is best treated as nostalgia and a yearning for the hypothetically less complicated mid-market of old. There are, however, more serious allocation issues to consider. Large investors say they have grown concerned in recent years that the act of allocating a proportion of their assets to the mid-market has been made almost meaningless by the dramatic expansion of what it now seems to accommodate. GPs, meanwhile, express irritation that some of the characteristics of the mid-market have been inaccurately appropriated by firms keen to benefit from the association.

Definitional concerns about the mid-market

GPs' concerns about the definition of the mid-market generally relate to the size of the transactions that are now covered by the term. "I think the mid-market has grown too large for its present definition. As far as we are concerned, any deal worth more than £100 million is a large deal and anything less than £10 million is small. The present definition is too broad." The intensity of frustration is correlated to the part of the mid-market in which the firm is active. Firms in the lower half of the sector are generally more vocal than those at the larger end. Firms of all sizes mostly agree, however, that the mid-market has expanded. "It has changed enormously over the last few years. Ten years ago a very large buy-out would have been a deal worth about £20 million. Actually, £10 million would have been getting there."

▲ GPs say the mid-market has now segmented.

GPs said the main effect of the dramatic expansion in the range of deal sizes covered by the mid-market had been to segment the sector. "The clear differentiator over the last few years has been the segmentation of the market...You can stratify the mid-market now. There are players at the top end who wouldn't play in the smaller end." They were comfortable with the idea that the broad definition of the mid-market was still capable of accommodating the different layers of the market, although there was some low level scepticism. "Everyone says they are in the mid-market but clearly people are operating in very different sectors." The perceived attractiveness of the mid-market to institutional investors was attributed to the inefficiency of the sector, and therefore the prospect for stronger returns relative to an increasingly competitive large buy-out market. This algorithm has been central to eagerness among some firms to be perceived as mid-market players.

LPs also expressed some concern about the extent to which the mid-market had ballooned. "It seems to stretch up to £250 million these days but it should not really be more than half that. The market is radically different today from what it was five years ago." The prevailing view was that this definitional growth had compromised the usefulness of the term. "Nowadays it seems to be everything that isn't venture but is not a mega deal. It's a catch-all for everything that can't be defined elsewhere. It is very amorphous. I don't think it is a very good description any more and it depends entirely on whose company you're keeping. It's a comfort description that is supposed to make you sound as if you aren't too greedy."

▲ LPs say the term is too broad to be helpful.

In some instances, however, LPs were even more agitated and felt that it actually impeded the way they wanted to construct their portfolios or communicate their investment decisions to committees or trustees. "It is difficult to work out what is and isn't mid-market any more. It's important to us from an allocation point of view because we need to be consistent when presenting prospective funds to our investment committee."

Forces for change in the mid-market

A range of factors have combined to create an irresistible force for change in the UK mid-market in recent years at a pace that far outstripped the rate at which it evolved in its earlier history. GPs and LPs are largely agreed on the main drivers. The massive increase in the size of funds that have been raised, a growing professionalisation among all the parties involved in the market, and broader financial market conditions were all identified as interrelated factors. Also important were a shift from volume investing to a more selective approach among most participants and the withdrawal of some hugely influential and longstanding players, albeit possibly only temporarily.

▲ The change has resulted from a number of factors...

The success of some groups in raising larger funds is a part of the wider growth in institutional interest in private equity triggered by the venture rush of the late 1990s. This emergent enthusiasm was underpinned by the protracted downturn in public equity markets and a growing appetite for alternatives as a source of absolute returns. The UK mid-market has also benefited from a shift in private allocations away from the riskier end of the investment spectrum towards those areas that are perceived to be lower risk. That has meant, for example, less venture investing over recent years and more mid-market commitments. The effect, regardless of a miscellany of causes, has been a big increase in capital flows into the mid-market. "It (the mid-market) has grown remarkably as the size of the funds under management has grown."

The so-called professionalisation of the mid-market has been reflected across the range of participants. The private equity firms themselves are typically larger than in the past, they are more attentive to their investors, and generally more rigorous and process-driven about their investment activity. Much of this has stemmed from competition and a pressure to perform. "Twenty years ago it was easier to make money. You could be very picky about deals. You paid lower prices. You could buy firms at less than net asset value. It has got a lot more competitive. Pressure to perform is increasing. Performance has become everything. And there has been an improvement in the performance of everyone," said one GP.

▲ ... from larger fund sizes to more intermediaries.

This has been compounded by the increase in spin-outs from banks, insurance companies and other financial institutions in recent years. Former captives have typically become much more aggressive and focused in the way they operate now that they are competing for capital against the other private equity firms. "The spin-outs have changed the dynamics of the market. You need to be able to tell a story. You can't just have 80 things in your portfolio with no specific strategy and hold them on the bank's account for a long time. It has become more about stock-picking than just playing the market."

This more selective approach to investing has also affected the way some of the remaining captives think, completing the shift across the spectrum of firms. "We would describe ourselves as a relative volume investor but the truth is we are not. There is almost no one in that world any more. I think people have realised that you will not make money if you do all the deals. You need an element of selectivity. The volume players were index players and now we all want to be outperformers." Also important have been the profound changes in the way intermediaries operate in the mid-market. The accountancy firms, corporate finance boutiques, and law firms are much more dedicated to the sector now than in the past. "Everybody has got more sophisticated."

While LPs share the same analysis of the forces for change, they are sometimes more concerned about the consequences. They argue that the overriding effect has been for established and experienced groups to get larger, sometimes leaving the mid-market altogether, with the result that overall quality is diluted. "It is increasingly hard to find the sort of teams you used to find. The UK used to be well endowed with competent to very good teams and now they are only ever really competent. The old are moving on and the good are moving out," said one LP.

Qualitative characteristics of the UK mid-market

▲ The term captures more than just deal sizes.

The quantitative definition of the UK mid-market captures deals that involve an equity investment of between £10 million and £100 million. However, most GPs and LPs feel strongly that there are a range of qualitative characteristics that are at least as, if not more, important in defining the mid-market. These can be broken down into the type of firms that operate in the sector, the type of deals, the source and quality of deal flow, and the type of vendors. There are clearly specialisms within these categories but the generalities produce a comprehensive qualitative description of the UK mid-market. This is represented in figure 1 alongside the characteristics of the large buy-out market by means of contrast.

Mid-market players

The type of firms operating in the mid-market is often considered one of the fundamental characteristics of the sector. "I tend to define the mid-market by the players and benchmark a deal against the actual investor. Some firms, for example, have grown a lot but they are still fundamentally a mid-market firm," said one GP. Sometimes this reflects the firm's history in the market and the generality that everyone was a mid-market firm 20 years ago. Sometimes it is more about their style of investment, "hands-on" rather than purely financial in approach. "They tend to be a bit more hands-on than in the large buy-out market. That's because they are usually dealing with smaller businesses and they are generally trying to make a difference at the company level." Historically, there were a fairly high number of captive firms, investing capital direct from a parent bank, insurance company, or pension fund. Most of these have now spun out and the market is dominated by independents.

Mid-market firms are both national and regional players. Most are based in London but many have regional offices and some have a full-blown regional network. Originally, the firms were dominated by executives who had spun out of 3i and had a background in accountancy. They remain an important part of the market but there is a much more varied apprenticeship these days. Most of the firms are generalist in approach but there is a growing trend towards sector specialisation. Team size ranges from fewer than 10 professionals to around 30, but most are towards the lower end of the scale. The typical fund size in the mid-market now stretches from £100 million to as large as £500 million with a handful of even larger examples.

▲ It relates to the type of firms investing...

Typical mid-market deals

The majority of mid-market deals are management buy-outs or buy-ins but they would also include some development capital investments and public-to-privates. "At our end you mainly see MBOs and MBIs where the management teams still have a reasonable equity stake," said one GP. The emphasis is traditionally on the quality of that management, who GPs say represent the decisive component of the investment decision. "Management is crucial at the smaller end and becomes less so as you move up in deal size."

GPs said mid-market deals were distinct in the extent to which they enable the investor to make a big impact on the operation of the business. "Once you get hold of a deal you can do things with it. You can have a significant influence on the company, its operations, and the management structure. You can really lead to a fundamental improvement in the way it does business," said one GP. The contrast is most striking with the large buy-out market, where investors are more focused on the financial structure of the opportunity. Accordingly, mid-market deals are also much more conservative in the way they are financed. "Most of the deals are financed using bank debt and mezzanine. They are definitely too small for bonds or securitisation. Financial engineering is not the be all and end all in the mid-market."

▲ ...the nature of the companies they back...

Mid-market deal flow

Deal flow in the UK mid-market is conspicuous for its volume. There is a lot of it. The number of firms in the sector, however, ensures that deal sourcing is highly aggressive and competitive, and one of the most important components of every firm's process. Some firms rely on regional networks for their deals but the majority of large mid-market deals are funnelled through London. One of the most important developments of the last few years has been the further penetration of intermediaries. A large proportion of deals are now sold through auctions, even if these are generally limited at the smaller end of the market. The intermediaries have also segmented in recent years. The large accounting firms are not as active as they have been historically, concentrating more on transaction support services. Corporate finance boutiques have become more important.

▲ ...and the source of deal flow.

Although intermediaries have grown in importance and influence throughout the market, there is still a much higher proportion of proprietary or self-generated deal flow in the mid-market than at the larger end of the buy-out market. Most firms now have sophisticated deal-sourcing activities, built around personal and professional networks and a range of other idiosyncratic activities. The ultimate corollary of this phenomenon has been the emergence of sector specialists, for whom one of the main motives for defining particular investment focuses is to refine their access to quality deal flow.

Vendors and exits

The majority of vendors in the mid-market are still private businesses but there are some public companies spinning out non-core units. Family vendors and entrepreneurs are a feature but perhaps not to the same extent as in the continental European mid-market. GPs and LPs alike said that vendors in the UK mid-market are typically highly sophisticated and were likely to have a solid understanding of private equity. This has the effect of making them easier to deal with than vendors in less developed markets but also more difficult to negotiate with on price.

The last few years have seen the emergence of private equity firms themselves as a significant source of deal flow. Secondary buy-outs have become an important part of the mid-market and are expected to remain so going forward.

Secondary buy-outs are obviously also an important feature at the other end of the transaction, the exit. The cyclical scarcity of other sources of liquidity has been reflected in a big increase in the number of secondary sales. Initial public offerings (IPOs) have not been a major exit route in the mid-market for some time and are not expected to resurface even at the upper end for the foreseeable future. That makes trade sales by far the most important exit channel. Recapitalisations have also been popular as a means of securing a partial exit in difficult conditions. The typical holding period for a mid-market investment is judged to be three to five years, longer now than during the late 1990s but comparable with exit activity for much of the preceding decade.

Figure 1. THE SEGMENTATION OF THE MID-MARKET

	Lower mid-market	Upper mid-market	Large buy-out market
Equity invested	• £5m - £15m	• £15m - £100m	• £100m upwards
Transaction size	• £10m - £50m	• £50m - £250m	• £250m upwards
Participant size	• Mainly independents • Some semi-captives & captives • National & regional players • Predominantly generalists • Competition from aquisition finance units	• Mainly independents & spin outs • Some semi-captives • Rare incursion from captives • Some sector specialists • Occasional interest from Pan-European	• Pan-European & others with multi-regional presence • US buy-out firms • All generalists • Rare capitives
Typical fund size	• <£200m	• £150m - £500m	• >£1bn
Typical team type	• Less than 10 investment professionals	• Between 10 and 30 investment professionals	• Upwards of 20 investment professionals
Transaction	• MBOs, MBIs • Some development & replacement • Mainly majority but some minority stakes • Occasional buy & builds • Not highly leveraged • Wide range of sectors	• MBOs, MBIs • Some public-to-privates • Predominantly majority stakes • Significant numbers of buy & builds • Some leverage • Wide range of sectors	• Predominantly majority stakes • Highly leveraged • Usually syndicated or club deals • Some cross-border consolidation plays • Wide range of sectors
Deal flow	• High volume of deal flow capital • Significant proportion proprietary or self generated • Small regional accountants or boutiques • Some limited auctions	• High volume of deal flow capital • High proportion of intermediated deal flow • Boutiques, accountants & investment banks • Small & large auctions	• Low volume • Almost entirely intermediated - almost all auctions • Large investment bank driven • Divestment of non-core assets
Vendors	• Generally private • Some corporate • Some families & entrepreneurs • Some private equity sellers • Generally highly sophisticated	• Private & public corporates • Some families • Some private equity sellers • Highly sophisticated	• Large private and public corporates • Some private equity sellers • Highly sophisticated • Some privatisations
Exits	• Overwhelmingly trade sales • Some secondary buy-outs • Target holding period typically 3 to 5 years	• Mainly trade sales • Increasing proportion of secondary buy-outs • Residual hope for public market exits • Some recapitalisations	• Trade sales • Trends towards more secondary buy-outs • IPOs when market conditions allow • Target holding period 2 to 5 years

Source: AltAssets Research

3. MID-MARKET DEAL FLOW

▲ The UK mid-market is characterised by a steady flow of deals.

The quantity of deal flow in the mid-market has been one of the main reasons for the sector's popularity among institutional investors in recent years. They are attracted not just to the relative maturity of the typical assets, but also to the dependability of that deal flow. This is in contrast to the early-stage opportunities that make up the bulk of venture capital deal flow. Regardless of the health of the broader economy, the UK mid-market has historically produced a steady stream of quality assets. That quantity, however, has also had the corresponding effect over time of inviting new entrants into the market and ensuring that there is a high degree of competition. The result is a great deal of attention on the part of both GPs and LPs to the way that firms source their deal flow.

One of the most conspicuous trends within the UK mid-market in recent years has been the extent to which private equity firms have been refining their deal sourcing activity. This has meant applying a minute focus on process as well as broadening their range of deal sourcing activity and their market profile. On the other side of the equation, LPs are also more thorough than ever in their analysis of a GP's deal sourcing capability. Their methodologies may differ but their determination to establish the integrity of a manager's deal flow is one of the most important parts of their own investment process.

The growing importance of deal origination

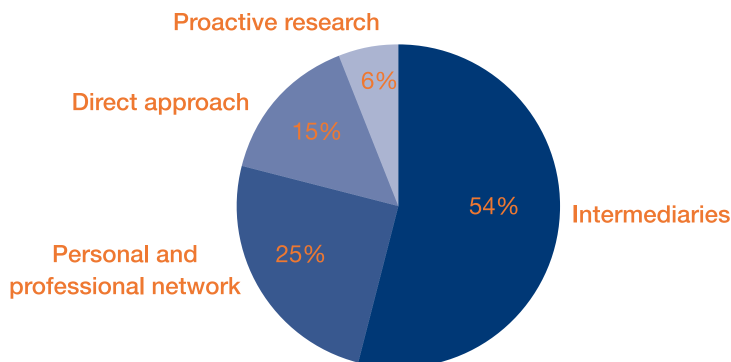
▲ Competition has put new emphasis on deal origination.

Deal origination has grown in importance as the competitiveness of the UK mid-market has increased. Everyone has a detailed process and many firms have cultivated an idiosyncratic methodology. This trend has simply been reinforced by the number of spin-outs streaming into the market in recent years and the downturn in fundraising across the private equity spectrum. The unrelenting focus on performance has installed a new discipline in every aspect of the business and rarely more so than in the deal origination. "We've concentrated on being focused as a house, not being busy fools. We look at a broadly similar number of deals but as an independent there is even more focus on our decision-making. You are completely devoid of any sort of excuse as an independent. The important thing over the last two years has been having a consistent methodology to identify quality opportunities," said one GP.

This evolution is another dimension of the end of a volume approach to investing and the preeminence of a more selective or focused strategy. "Our view is that the whole business needs a lot of focus. The volume and portfolio approach doesn't lead to good investment decisions. You need to be attentive to your investments and that leads you down the route to saying that you need to be more selective," said one GP. The next step from this strategic decision has been to build some rigid process around the ambition. "The way deal flow works now presents an operational challenge. It needs to be maintained. You need a standard process." This, in turn, has been reflected in more regimentation across all the other parties to the deal. "Twenty years ago the bulk of deals were done without a lot of support and investors took a portfolio approach. It is much more structured now and the professional firms sell their services much more aggressively these days."

Sourcing deals

Figure 2. SOURCES OF DEAL FLOW



Source: AltAssets Research

UK mid-market firms originate their deals from a range of sources but the most significant is the varied gallery of intermediaries. (See figure 2.) Some 54 per cent of deals come from corporate finance houses and boutiques, accounting or legal firms, or other financial advisors. Another 25 per cent is sourced from personal or professional networks, 15 per cent from direct approaches, and just six per cent from proactive research.

The importance of intermediaries is evident in the lengths to which mid-market firms will go to cement or improve their relationships with them. "The accounting firms are very well structured. We spend a lot of time letting them know what we are doing. We keep open our line of communications because it is critical," said one GP. Firms use a wide range of techniques to keep open those lines of communications, from advertising to direct marketing and informal approaches to lunching. Each has its place depending on the location in the mid-market and the predominant form of intermediary.

▲ Intermediaries have grown in importance.

Even where firms are able to use their personal networks to source deals they are usually subject to some sort of competition. The hope is simply that by getting a look at a deal in the earliest stage or access to the management ahead of competitors the potential purchaser can establish an insurmountable advantage. "We have been trying to maximise our direct sourcing capability. It means you are in there earlier and have more chance of converting the deal on the right sort of terms. It's all about research, and phoning, and building a network."

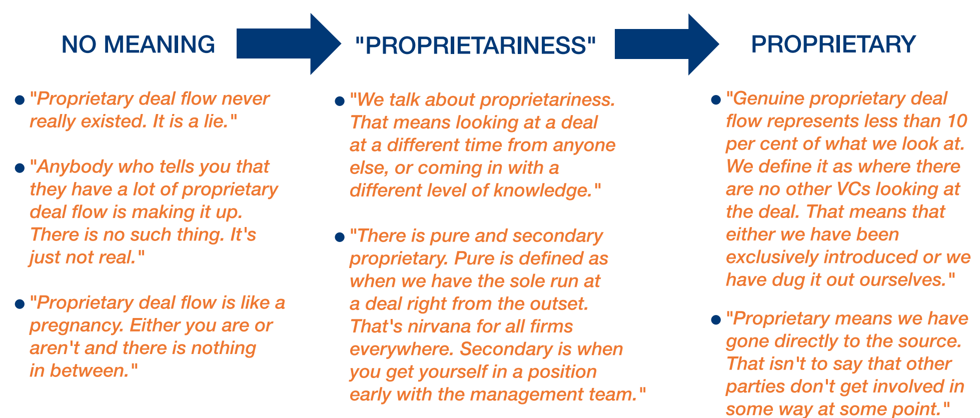
Intermediaries

The growing sophistication of intermediaries is an important aspect of the greater maturity of the UK mid-market. GPs say the professional services firms have both become more focused on private equity in recent years and they have shifted around the parts of the market in which they are active. The large accountancy firms, for example, are less significant now as deal providers while the boutiques are more important. The effect is largely benign and most GPs said they felt deal flow was now more accurately channelled.

"Intermediaries have definitely become more focused in the way they do their business. Boutiques, for example, are more of a factor. A lot of good people are now independent and that means doing business in a different way. We have certainly seen an increase in our deal flow from boutiques," said one GP. This has typically been mirrored by a withdrawal of the large accountancy firms. "We are dealing with different institutions to the ones we used to deal with. The big four have become much more focused on servicing us than originating deal flow. They seem to think there is more value in supporting the transaction and cross-selling their services than in originating the deals. That means that when sourcing the deal flow you are dealing a lot more with boutiques. They are now the most important form of intermediary for us."

"Proprietary" deal flow

Figure 3. THE MEANING OF PROPRIETARY DEAL FLOW



Source: AltAssets Research

▲ GPs are sceptical about the meaning of proprietary deal flow.

Proprietary deal flow has become, at best, a relative rather than an absolute concept. It no longer means that a deal is entirely exclusive to a GP from origination to completion. Instead, it means that it is subject to less competition and possibly just some sort of edge or advantage. Some GPs think that the term has been devalued to the point of almost uselessness but others still feel it is a helpful concept. LPs are certainly more binary in their definition: either a deal is proprietary or it isn't. The resolution of that question is an elemental part of their analysis of a firm's deal origination capability.

Figure 3 illustrates the range of different meanings attached by GPs to the term proprietary. However precisely it is defined, GPs agree that it is a rarity in mid-market these days. "I would be amazed if ten per cent of the deals done in the mid-market were fully proprietary. In fact, I would be amazed if five per cent of them were. But 60 per cent of our deals done would have some of the necessary elements, either being closer to the people or gaining an advantage by going to them at the right time," said one GP.

Changes in the quality of deal flow

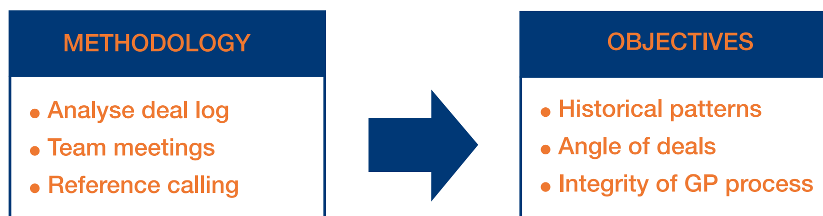
The volume of deal flow in the UK mid-market is generally judged to be highly dependable. Broader economic conditions, however, do sometimes contribute some volatility. The last couple of years, for example, have seen the quality of deal flow compromised by a deeply uncertain macro-economic outlook and a challenging operating environment across most business sectors. GPs said the resulting slowdown in investment activity had affected the behaviour of intermediaries, sometimes with unwelcome effects. "We have seen a lot more deal flow over the last 18 months that doesn't have a vendor. They are interesting businesses but they are not for sale. The problem stems from corporate finance firms wanting to keep themselves busy. The effect is that we have seen a massive rise in the number of deals being shown our way but no increase in the number of investment papers we need to prepare. That has been a totally unhelpful development," said one GP.

Over the longer term, however, GPs said the quality of UK mid-market deals had improved considerably over the last 20 years. "When we started out in the early 1980s we logged 350 deals a year. The deal volume ever since then has averaged between 325 and 400 deals per annum. The characteristics of the deals, however, have changed a lot over that time. I think that partly reflects that we have got better at communicating what we will or won't do. Ten years ago a lot of rubbish was coming off the streets but these days that sort of stuff has gone. A lot of the deals now are pretty serious opportunities," said another GP.

▲ The quality of deal flow has improved over the last decade.

The LP approach to analysing deal origination

Figure 4. HOW LPs ANALYSE GPs DEAL FLOW



Source: AltAssets Research

LPs say that analysing a mid-market firm's deal origination capability is one of the most important parts of determining its attractiveness as an investment opportunity. They all adopt a similar approach, combining desk-based due diligence, team meetings and extensive reference calling. The ambition is to uncover historical patterns in the firm's investment activity, how often the GPs have been able to win themselves a competitive advantage and to test the integrity of their process. (See figure 4.)

▲ LPs think a firm's access to dealflow is critical.

"Assessing the quality of a firm's deal flow is critical for us. We ask to see the minutes from team meetings, we look at their deal flow log and all the related documentation and then we look in detail at every deal they have done and ask where they come from. We spend a day with the GPs and it is one of the first topics we look at," said one LP. Reference calling is also fundamental. "We reference the intermediaries and ask them why they approached the firms that they did." Speaking with the management of existing portfolio companies is also important. "You can cross refer by asking the CEOs of portfolio companies whether they talked to other private equity firms before doing the deal."

Relationships with existing fund managers can be insightful for LPs. "We base our assessment on what we know about the market and what else we know is going on. We have a lot of industry knowledge from talking to lots of funds so we know if more than one group is claiming the same deal to be proprietary."

Most LPs are looking for the same sort of things. They like to see a structured and consistent approach, evidence of a well entrenched network, and clear signs that the firm is often able to work itself into a competitive position. Proactivity rather than anything as nebulous as proprietariness is the key. "We want to know they can unearth a deal from their existing relationships," said one LP. "What we like to see is that funds proactively go out and call on companies to create their deal flow. Anyone can have a high number of deals passing over their desks. We want to see that they have been proactively developed."

A proven approach is all that matters, rather than any particular methodology. "We don't have a preference for one source over another but we think it is very important that they have a structure to their deal sourcing. For some that might mean a deal club. For others it might mean schmoozing the regional accountants or having a sector focus. There isn't just one way to heaven but they do have to be part of some sort of network. We are looking for a discernible pattern," said another LP.

4. INVESTING IN THE MID-MARKET

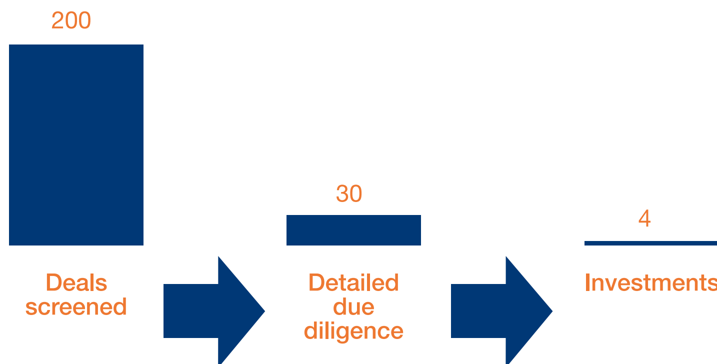
The pace of investment among individual UK mid-market firms has slowed considerably in recent years. This has largely been a function of the adoption of a more selective investment strategy at the expense of traditional volume investing. It has, however, also been compounded by cyclical factors and the requirement for many firms to increase the time they spend on their existing portfolio companies in an uncertain economic environment. Most GPs predict a gentle increase in their investment activity over the next few years, with an average target number of four deals per annum, but they expect to remain much more focused than in the more distant past.

▲ Almost all GPs are selective rather than volume investors now.

GPs said the most important factor informing their investment decisions in the mid-market was the quality of the management. The other outstanding considerations were growth potential and exit opportunity. LPs broadly agreed, although they attached slightly more importance to exit opportunity, in keeping with their purer and more immediate financial concerns. There is a more striking difference of opinion between the two parties when it comes to the growing popularity of explicit sector specific investment strategies. A majority of GPs feel there are significant benefits to that greater degree of specificity, although their understanding of exactly what constitutes sector focus differs widely. Most LPs, however, are either undecided or put off by a specific focus.

Pace of mid-market investment activity

Figure 5. DEAL SCREENING TO INVESTMENT



Source: AltAssets Research

The average UK mid-market firm makes about four investments a year. For most of them that is significantly lower than in the past but it reflects the evolution of the sector into a more competitive and professional marketplace. The performance imperative, a function of less supportive financial parents and a more difficult fundraising environment, has sharpened firms' ambitions to be much more selective about their investing. GPs said the slowdown had also resulted from the implementation of a much more exhaustive investment process. "Deals have become very long in process, quite a bit more expensive, and more problematic. You have to put a lot more time and money into the deal and you don't want to do that speculatively. You want to make sure that when you commit the resource it isn't going to be wasted. You want to really know at the outset that it is something you want to do," said one GP.

▲ Deal transaction takes much longer now than in the past.

Most firms said their investment pace had slowed further in the last couple of years as a result of the deterioration in the wider economic conditions. This had made it much more difficult to be confident about a company's growth prospects and market place. "The slowdown in our investment activity has been in part because we have refined our strategy and in part because recent market conditions have made people more cautious," said another GP. The aggregate result is that firms aim to complete an average of about four deals per annum, a completion rate of about two per cent of the opportunities they screen through the course of the year. They perform due diligence on about 15 per cent of those opportunities but there is a wide divergence from one firm to another depending on the degree of investigation they undertake at a preliminary investment phase. (See figure 5.)

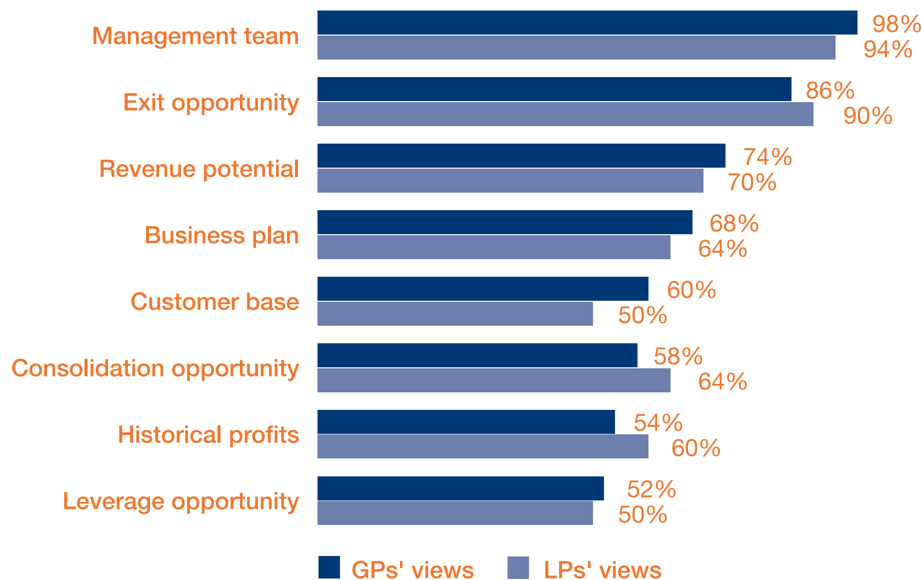
▲ Investment pace is expected to pick up speed after a couple of slow years.

Investment pace, however, is generally expected to increase as the economic gloom clears and visibility improves. "There are clearly signs that the market is starting to pick up," said one GP. "I think the pace will pick up again over the next few years. We have the capital. Other people need to do deals. The momentum is there. We are all pretty cash rich and it will gradually lift off," said another. The general feeling was that this was the best moment in the cycle to be investing, when prices were still low and competition from trade purchasers in most sectors was still subdued. "We think this is a great moment in the cycle. Vendors are more realistic. Some of the competition is preoccupied with their existing portfolio companies and the strategic buyers are still pretty scarce."

Most LPs agree, even if only because they are reflecting the intelligence gathered from their fund managers and the general geography of the market. "Going forward we think that things will pick up. The increased population will create activity and deal flow. There are definitely signs that things have picked up this year," said one LP. A handful, however, were more sceptical and felt that there were both structural and cyclical reasons to be more circumspect. "You can only buy if people want to sell. Valuations are still a bit of an issue and the level of due diligence these groups carry out now is much more intense. They are more cautious and they won't leave anything open to chance. The debt market is also exceptionally tight," said one LP. "I'm not convinced it is going to accelerate much. I don't see any structural or market reason why it should. Pricing is tight but not that tight. Vendors who aren't selling aren't being held back because they can't get the right price. They aren't waiting for higher prices," said another.

Investment decision-making in the mid-market

Figure 6. FACTORS AFFECTING THE INVESTMENT DECISION



Source: AltAssets Research

▲ The quality of management is key in prospective deals.

The market is fairly consistent in identifying the most important considerations in investment decision-making. The quality of management, the growth potential and the exit opportunities are typically identified by both GPs and LPs as the pre-eminent criteria. (See figure 6.) Market share is also important. They are all interlinked and none would be enough in itself. Organic growth potential has also assumed greater importance than ever in the context of present market conditions, which are not expected to be as supportive to private equity investors as they were for most of the last decade.

The role of management is one of the defining features of the mid-market. If the ambition of most investors could be distilled into a single objective it would be to back a team capable of significantly enhancing and extracting the value of their company. The management holds the key to unlocking that value, even if it requires the guidance and muscle of their private equity backers. "Management is the primary consideration. That means having a good blend of people in place to take advantage of the opportunity to add value to the deal by improving the business," said one GP.

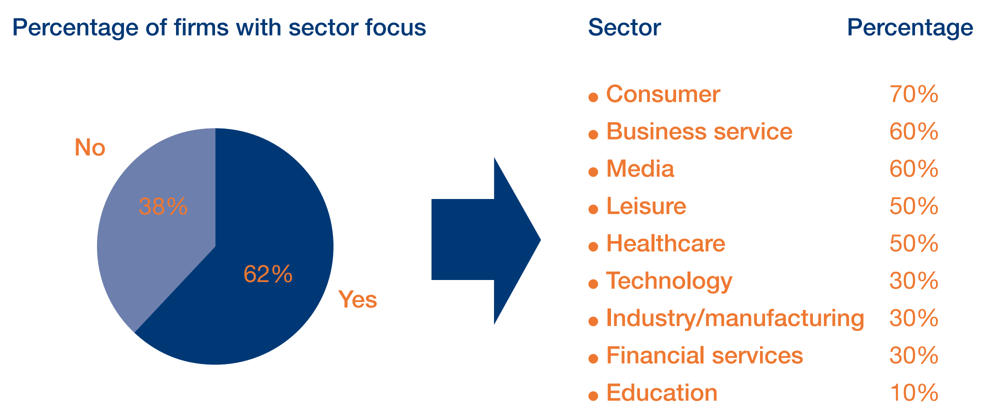
Every mid-market firm has its own way of describing the sort of attributes it is looking for in a management team but there are some common themes. They like to see a team that is proven and is totally in control of its business. "The management team is absolutely critical. They don't need to be in place in their entirety but there has to be a skeleton and a track record, something that gives you a clear understanding of there being a team that has a grip on their business." And they like to see a team that is capable of thriving under greater responsibility and can take the company to another level. "We look for a management team capable of running a bigger business."

The growth potential of a prospective investee company is also critical, particularly in an environment where multiple arbitrage is unlikely to be a source of returns in the way it has been in the past. "You really need to see real growth prospects." Exit opportunities are also important, although GPs say they are looking for potential rather than a detailed plan. "Exit is always a discussion before the investment happens. We do a fair bit of work on that, looking at who will be buying the business," said one GP. "An exit is not the be all and end all but if there is no end in sight then we wouldn't want to do it," said another.

It is the amalgam of these criteria, in conjunction with secondary considerations such as market share, that define the most attractive mid-market opportunities. Most firms, however they prioritise the various categories, are looking for similar things. Also a defining feature of the mid-market, albeit for contrasting reasons, is the relatively low importance attached to leverage as part of the investment decision-making process. "Leverage is a factor but we are not going in on that basis. We don't invest specifically to get rating arbitrage or good leverage returns. They are just tools of the trade."

Sector specific strategies

Figure 7. MID-MARKET FIRMS WITH AN EXPLICIT SECTOR FOCUS



Source: AltAssets Research

▲ Sector specialisation has become much more common among GPs.

Sector specialisation is not exactly new but it has become much more common in a very short space of time. The last few years, coinciding with the arrival of more spin-out groups and the growing prevalence of a selective approach to investing, have witnessed a wave of firms adopting an explicit sector focus. Competition and the need for ever greater differentiation have also been contributory. "Sector focus is becoming even more specialised. It isn't just sectors now. It is sub-sectors. The main driving force behind that has been competition," said one GP. Figure 7 shows the popularity of the various sectors among those firms that have an explicit focus.

There are, however, several tiers of sector specialisation. There are firms that have dedicated sector teams and do not stray from those areas. "We are organised in sector teams and that is exactly how we invest." There are firms that have specialists but allow themselves the freedom to pursue any opportunities they see fit. "We have developed our sector expertise by dint of doing deals in certain areas." And there are firms that are straightforward generalists who have opportunistically and retrospectively imposed some sector specialisation on their activity where patterns have emerged. "We introduced an explicit sector focus when we started marketing our last fund. In reality, most of the market sectors fit within one of our boxes so we are still quite generalist but there is a sort of focus developing."

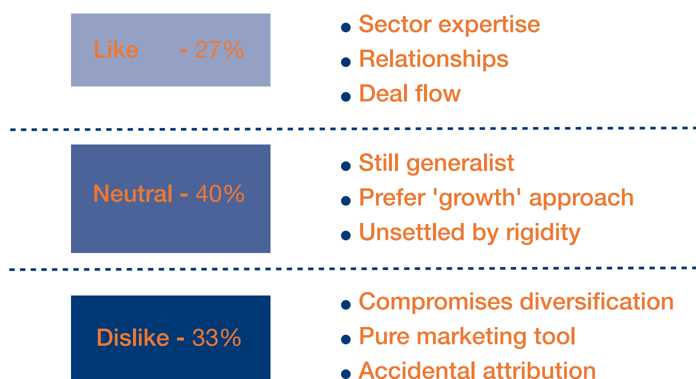
GPs say the primary importance of a sector focus is as a means of refining deal flow. It sends a clear signal to intermediaries and prospective investees about the firm's interests. It is also judged to be an advantage when reaching investment decisions, working with a portfolio company, and steering portfolio companies towards an exit. "Sector focus is useful for marketing. The media, such as the trade press, are defined in sectors. Increasingly a lot of intermediaries are also set up to support sector-based activity. It also helps with execution and decision-making. We know the sector. When a deal comes along and we're interested then we are already a few steps down the path. It allows us to establish credibility with the teams," said one GP.

Some firms said there had been a measure of opportunism about their initial decision to adopt a sector specific focus but had subsequently been convinced of its usefulness. "I was initially a sceptic about sector focus but I am now a complete convert. It does get you more proprietary deal flow and often it is of a higher quality. You get stuff from the sector specialists at the intermediaries rather than from the generalist teams. You get to know the right people in the different industries. You get better at spotting opportunities and seeing what is and isn't special. It is also easier to add value at a portfolio level. It is incredibly compelling once you are living it," said one GP.

▲ Specialisation is judged to refine deal flow.

There are some entrenched sceptics, however, within the ranks of UK mid-market firms. They question both the integrity of a lot of sector specialists and suggest that it is usually just employed as a synthetic means of differentiation. "Having a specific focus is just a selling tool. The market has got a lot more competitive and it is now a mature industry. People are on the lookout for different ways to market themselves and selling angles," said one GP. Others accept the concept but argue that there are very few genuine practitioners. "I can only really think of one UK mid-market firm that is really sector focused. Otherwise we are all pretty much generalists."

Figure 8. LPs' VIEWS OF SECTOR FOCUS



Source: AltAssets Research

Figure 8 shows that LPs are generally undecided about sector specialisation. They acknowledge the benefits but are concerned it might involve them assuming an unwelcome amount of sector risk. Some are sceptical that it is more of a marketing tool than a declaration of investment discipline. That feeling has been reinforced as much by the short space of time in which it has emerged as a popular strategy as by the idea itself. LPs are, however, inclined to think that the UK mid-market, particularly the upper end, probably merits some specialisation in a way the less mature continental European mid-market does not. Its viability is partly a function of the volume of deal flow.

▲ LPs are undecided as yet by specialisation.

Scepticism among LPs centres on the extent to which it was really just opportunistic. "A lot of them will profess a specialist approach but all they have done is to go back through the deals they have done and looked for a pattern that is purely accidental," said one LP. Others dismissed it as fashion. "Some sector specialists have real knowledge and experience but a lot have developed a sector specialisation by following the latest fashion. By and large it makes me nervous because it is generally marketing bullshit," said another.

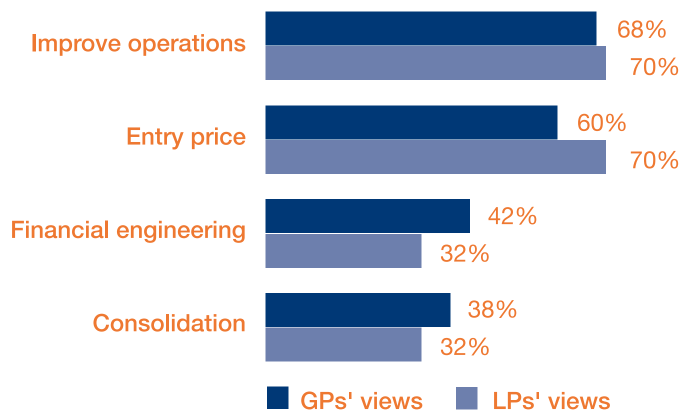
Enthusiasts said they valued the extent to which it gave the GP a competitive advantage, sector expertise and a higher proportion of relevant deal flow. "The benefit is that it brings industry expertise. That's the problem with the buy-out business. A lot of groups see deals and then need to learn about the whole industry very quickly to work out whether they are attractive or not. If you know about the sector you can vet the opportunities much faster and have a good conversation with the management right from the start." Those LPs that were neutral tended to express gentle concerns about diversification and said they preferred to look at it on a case by case basis.

5. GENERATING RETURNS AND ADDING VALUE

Discussion about how mid-market firms generate their returns and add value to their portfolio companies can quickly descend into a semantic tangle. These are difficult things to discern reliably and some firms have reinterpreted their history to make it more appropriate for what they expect the future to be. There are, however, some clear themes that emerge. The first is that the most important driver of returns in the mid-market, if it has not always been, is now the ability to make operational improvements to portfolio companies. This is closely followed by the entry price. There is then a big gap back to financial engineering or consolidation. GPs and LPs agree that there is a new emphasis on operational improvement to reflect a deterioration in broader market conditions and an acknowledgement that the strategies of the past are not likely to be as fruitful in the future.

Drivers of returns in the UK mid-market

Figure 9. KEY DRIVERS OF MID-MARKET RETURNS



Source: AltAssets Research

▲ Operational improvements are considered the key to generating returns.

Figure 9 shows that some GPs argue that making operational improvements to their portfolio companies has always been the most important driver of their returns. "We've had this strategy since the early 1990s recession. It was obvious that the financial engineering we had seen at the end of the 1980s was not going to be sufficient for a different environment," said one GP. "We estimate that about two thirds of our money has been made by improving the operational performance of our portfolio companies," said another. Others acknowledge that its preeminence is a relatively new phenomenon. "We definitely pay a lot more attention to improving the operational performance than in the past. We were really just paying lip service to the idea until recently," said another. They all agree, however, that it will be a fundamental part of their business going forward.

GPs are highly conditional about buying at the right price, reflecting the proximity of the top of the cycle and the pertinence of its volatility. In other words, the experience of buying at the wrong price is still very fresh for some firms. Accordingly, the consensus is that price cannot safely be extricated from other considerations without leaving the investor exposed to swings in the broader market. "We've been a believer that buying cheap wasn't really going to happen any more. Our model has always been to spend quite a lot of time with the company."

GPs also conceded that the competitiveness of the UK mid-market and the sophistication of most vendors meant it was unrealistic to expect bargains to drive returns across the entire portfolio. "Clearly you don't want to overpay but I don't think that buying at a low price is the panacea to good investment. These days, where guys are very good at selling, you have to pay up. If you want decent quality assets you have to pay. It's nice to feel that you've got something for a steal but in this sort of environment that is always going to be for the wrong sort of reason."

▲ Financial engineering is not an important part of the mid-market.

The ability to leverage investments is important but still secondary in the quest to generate returns. Most mid-market firms said that they did not expect to be able to finance their deals with anything more than an equal measure of debt to their equity. "If it is a logical part of the deal and does not undermine your ability to grow then it is important but it is always secondary," said one GP. This very different balance between operational and financial risk is one of the most important differentiating characteristics between the mid-market and the large buy-out market. Operational risk is generally perceived to be much less significant in large MBOs, where the main objective is to finance mature and dependable businesses creatively.

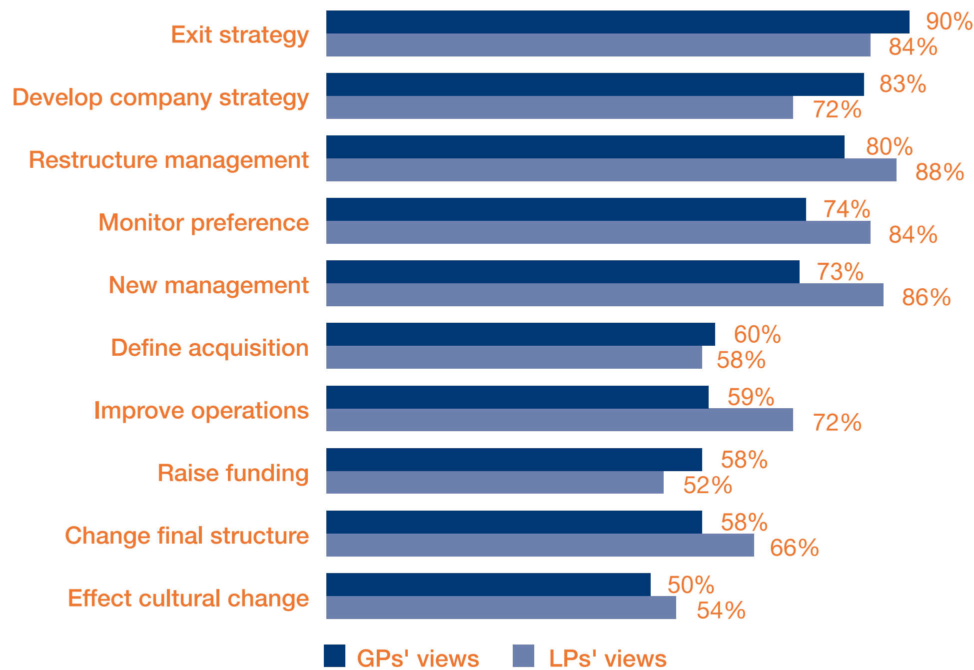
LPs say they have recognised a clear shift in emphasis among GPs towards operational improvement. "We have definitely noticed that GPs stress their operational focus a lot more now than they did a couple of years ago," said one LP. Some of them offered a gently cynical explanation for this trend. "There is definitely a lot more focus on operational performance than prices at the moment, probably because a lot of firms paid over the odds for their investments over the last few years." Others said it simply reflected market conditions. "They have got to go back to doing things with the company because there really isn't any scope for financial engineering at the moment."

They tend to place more importance on entry price than the GPs, presumably because they are afforded a more candid and retrospective analysis of value creation. They do not have to defend portfolios that feature companies purchased at the top of the market for which no amount of operational improvement will heave the valuation back to purchase price. "Firms tell us that improving the operational performance of their portfolio companies makes the difference. I guess I'm old fashioned because I still think that buying at low prices increases the chances of generating a good return on the investment," said one LP.

Most LPs, however, prefer to look at the question of generating returns as a series of interrelated factors rather than trying to strip apart the different components and attach separate values. "The key thing is to buy well, to grow and to sell. It is all intertwined. If you miss any element then it won't work. You can't really leverage these things anyway. You just have to transition the company and put it where someone wants to buy it," said one LP. "Returns should in theory come from improving the operational performance of a company. We try to break it out where we can. But it is also highly important where the markets are. If you exit a good company in a good market then you will get great returns. But if you exit the same company in bad markets then the returns won't be so good. The market environment is very important but firms don't have any control over that," said another LP.

Adding value to portfolio companies

Figure 10. ADDING VALUE TO PORTFOLIO COMPANIES



Source: AltAssets Research

▲ Most GPs say they get involved at a strategy level...

Analysis at a company level finds a different expectation of how GPs can help to improve operational performance and, indeed, a more particular definition of what that actually means. Whereas previously it ostensibly related to the way the buy-out firms try to make their investee companies stronger and more profitable businesses, at the individual company level it refers to the core processes and activities that make up the way the company works. In other words, it is a form of shorthand at the portfolio level but relates to operational detail at the company level. And at this level GPs say they are typically more concerned with strategic rather than operational issues. They consider their main contribution to be strengthening and supporting management to be best able to implement the defined strategy. It is not about wandering around on the factory floor.

Figure 10 shows the main ways in which GPs think they add value to their portfolio companies. The most important is determining exit strategy. "It isn't something that the management team itself would think much about because for them it is about a job rather than an investment strategy." This is followed by helping to develop company strategy, which is usually achieved by working at board level. "We are active at a board level so we like to bring in a non-executive chairman and help fill vacant board seats but we don't really operate much beneath this level....This is where we want to help out with company strategy."

Most GPs said they felt this was the area in which they made the most immediate impact because the management in a lot of mid-market companies often did not have much experience in setting strategy. "The strategic issues are about getting the business to actually think and plan strategically about where they are going. A lot of them have never thought about that sort of thing. It is amazing how many companies have never had a strategic awayday."

Improving operations in the more detailed sense came some way down the list of priorities for most GPs, reflecting the distinction they make at the company level. "We get involved at a board level because that is much more important for us than walking around the factory floor trying to tell the managers what to do. I don't believe that VCs are capable of doing that sort of thing. That's where you get in consultants," said one GP. "We don't drop our own people in unless there is a very tight situation. We are backing the management to run their own business," said another.

Some GPs, however, do see it as their role to get involved at the more granular as well as the strategic level. "We break it down into strategic issues and operational issues. The operational issues are things like reporting standards, cash management, and reviewing core processes and the general running of the business. We use consultants and our own people depending on their requirements. Sometimes a firm has massive inefficiencies in the way it is run and consultants can really help. Other times it is more productive to put some of our own people in," said one GP.

▲ ...but some get involved more intimately with portfolio companies.

A gently growing number of mid-market firms have, in fact, begun to develop their in-house resources to be better equipped to effect change at the company level. Instead of restricting their involvement to the board, they have recruited portfolio specialists who focus solely on working with companies and are largely divorced from the investment process. "We have a portfolio team. They are not deal doers. They have no more than five companies to work with each. They work at both a strategic and an operational level. So if someone says there is something broken in the sales department they will spend a week looking at how it works....We experimented with the idea first and then started to believe. It should be measurable in our returns. People who add more value to their portfolios will make more money."

LPs did not express much opinion about adding value. The general feeling was that private equity firms should identify the strongest possible management to ensure the businesses were well run. "I don't regard that in essence they (private equity firms) add much value. It's the things that surround the strategy rather than the operations. In other words, they effect operational change by making sure the strategic components are in place and the management team is capable of executing them well," said one LP. At best, the GP could make sure that their executors, the management team, were capable of fulfilling their objectives. "Management is the critical factor. The financial investor is there to monitor performance and to take action if necessary, but it is the management that is responsible for execution."

6. COMPETITION IN THE UK MID-MARKET

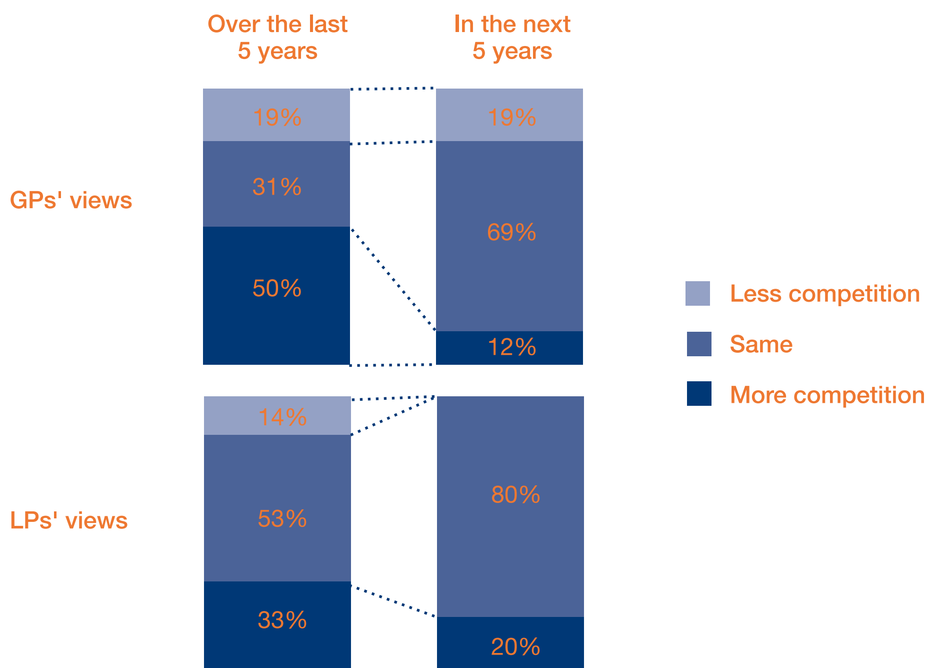
GPs and LPs feel that on balance the level of competition in the UK mid-market is broadly the same today as it was five years ago. What has changed has been both the nature of that competition and the levels of competition in the different parts of the market. The volume players have largely exited the market or evolved their strategy and most firms are now selective about their investing. There is also a feeling that the lower end is significantly less crowded than the upper end. In aggregate, the mid-market is judged to be highly competitive but not necessarily more so than in the recent past. That is expected to remain the case going forward and some GPs even expect the population to contract slightly.

▲ The nature of competition has changed in the UK mid-market in recent years.

Where firms said they had experienced more competition over the last few years it had overwhelmingly come from local firms. The UK mid-market is judged to be too competitive and mature to accommodate overseas players. The barriers to entry, primarily experience and network, are considered almost insurmountable. The GPs who complained that competition had intensified in recent years said the main effects had been to make deal sourcing a more aggressive undertaking. They also pointed to more auctions. They were less convinced it had made much of an impact on their returns.

Changes to the level of competition

Figure 11. CHANGES TO COMPETITION



Source: AltAssets Research

Half of GPs said competition in the UK mid-market had grown over the last five years, 31 per cent said it was the same, and 19 per cent said it had actually become less competitive. (See figure 11.) These figures, however, do not capture the extent to which a lot of firms felt that there had been changes to the complexion of competition more perhaps than to its intensity. "The smaller end has become less crowded and the upper end more crowded," said one GP. "There is not necessarily more competition but the competition has got better. There are no easy pickings," said another.

▲ The upper end is considered more competitive.

The shift from the lower to the upper end of the market was a common observation. Generous fundraising conditions until relatively recently had enabled some longstanding mid-market firms to increase their assets under management dramatically. That in turn meant they had had to shift their focus onto larger deals to invest the entirety of their fund within a reasonable time frame. "It's (competition) probably broadly similar but some of the smaller guys have grown up and the bigger guys have got bigger funds," said one GP.

Other GPs, however, insisted that there was actually less competition now than in the past. They argued that the private equity industry in general had matured to the extent that almost all the active firms had a particular stage or sector focus. That meant that rather than the entire universe entertaining ambitions of investing in the mid-market, now it was only mid-market specialists, numerous though they might be, that operated in that space. "The market is much less competitive now than it was a few years ago. Five years ago almost anyone in the BVCA Directory would have been prepared to do a £30 million deal. Then in 1998 some of the buy-out houses started raising much bigger funds and they couldn't do smaller stuff any more," said one GP.

The LPs were marginally more inclined to think that competition had remained unchanged over the last five years. Only 33 per cent thought it had intensified, while 53 per cent said it was the same and 14 per cent said it had actually decreased. They echoed GP's views about the smaller end of the market. "The smaller end of the mid-market is not very crowded. The new entrants tend to be at the larger end." And they had similar feelings about shifts in the identity of some of the participants that did not necessarily have any aggregate impact. "Everyone changes but the absolute level of competition is about the same."

▲ Some LPs are concerned that there may be an oversupply of capital.

A handful of LPs, however, did express concern that the growing interest of the wider investor community in the mid-market risked creating damaging levels of competition. Accepting the blame for a potential oversupply of capital, they argued that an ongoing risk aversion on the part of LPs might eventually have the effect of driving down returns. "The question now is whether the market is overfilled. It has been driven by demand. People found they could raise larger finds than they had expected. Institutions were looking for funds that were smaller than the mega funds and that benefited the mid-market guys. Investors are always to blame for competition. There was an awakening to the mid-market generally a couple of years ago and now there is probably too much money."

Others acknowledged that there had been a big rise in institutional interest in the sector but suggested that had affected the language of marketing more than the actual geography of the mid-market. "There are a lot more people calling themselves mid-market these days but I think that is just in response to what they think investors want to hear. Most of the growth in the UK mid-market population happened in the early 1990s."

Future competition

▲ Competition is expected to remain stable over the next few years.

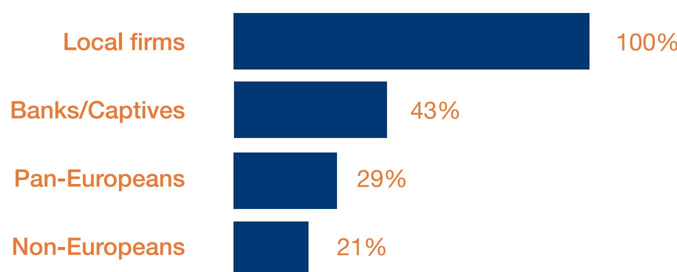
Competition is expected to remain fairly stable over the next few years, mainly because the barriers to entry are so high. Some GPs even suggested competition would ease. "I think it will more or less stay the same over the next couple of years but there will be some change beyond that. I think that there will be some consolidation and shrinkage in the number of firms. Investors increasingly have issues and they are becoming more selective," said one GP.

The biggest concern expressed by GPs was the possibility that some of the firms that had disappeared out of the top of the mid-market might drop back down in response to the difficulties they were having investing at sufficient speed in the large buy-out market. "It could change more if the big guys move down. There are not that many deals in the mid-market so if the big guys come down they will destroy pricing." The general view, however, was that investors would put the brake on big funds relocating. "There has been some talk about the bigger houses moving down but the skill sets are different and investors are bound to have something to say about that."

Only 20 per cent of LPs thought there was a risk of more competition. Most of them said it was too competitive to attract new entrants and that the scarcity of new capital would make their arrival unlikely anyway. "It's a mature industry now. All the people operating in the UK mid-market are experienced. There is no need for any more participants," said one LP. "We don't think competition will grow because that would depend on an influx of new capital and we don't think that is going to happen," said another.

Sources of competition

Figure 12. SOURCES OF COMPETITION



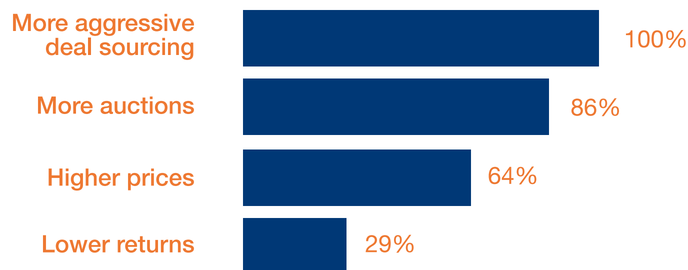
Source: AltAssets Research

Where there has been an influx of new players over the last five years they have generally been local firms. (See figure 12.) Some firms at the lower end, however, complained about some competition from banks. "The acquisition finance community has upskilled enormously over the last decade. They are doing deals now that might well have been private equity deals a few years ago," said one GP.

Some firms also said that the UK mid-market had felt secondary effects of growing competition in the continental European mid-market. Firms that had once harboured ambitions of investing in the continental market had now pulled back into their local market. Most GPs, however, agreed that the mid-market was too crowded and complex for the major financial investors from the US to explore.

Effects of competition

Figure 13. EFFECTS OF COMPETITION



Source: AltAssets Research

The biggest corollary of greater competition has been a new aggression about deal sourcing. (See figure 13.) That was cited by all the firms and investors that said the market was more competitive now than five years ago. "The main effect on us of there being more competition is to be more proactive about our deal sourcing because we don't like participating in auctions. We make an extra effort throughout the firm to market to our proprietary network," said one firm. "People are really scrapping now to find quality deals that you can get some sort of advantage over," said another. LPs agreed. "Firms have been forced to get a lot more professional about deal sourcing."

▲ LPs blame competition for the rise in auctions.

LPs were also particularly concerned that greater competition lay beneath the growing prevalence of auctions in the mid-market. "You never used to hear about auctions in the mid-market but there are lots of them now, even if they have limited participants," said one. Auctions are generally regarded by LPs as the antithesis of market inefficiency and therefore a threat to returns in the sector.

Barriers to entry

GPs are acutely aware that it is going to be much more difficult to raise money in the immediate future than it has been in the recent past. Accordingly, they rate the availability of capital as the most significant barrier to entry in the UK mid-market. "The limited partner community is definitely going to be more conservative in the coming years. LPs are far more sophisticated than they used to be. They have really grown up in recent years. They do differentiate much more between sectors and stage. That is going to keep us focused. They want to see a track record and consistent investment methodology, for example. We are going to be examined very closely," said one GP.

A network to secure quality deal flow was also considered vital by GPs. "It's deal flow that creates the biggest barrier to entry. It is certainly very difficult for remote participants to attack it. A contact base is essential," said one. There was also a feeling that the amount of experience and effort required to make a success of mid-market investing was often underestimated. "The main barrier to entry is the amount of hard work involved. I don't think people will move back down because the skill sets are very different. The upper part of the market is very financially-driven. The mid-market is more focused on working with management. We're at the grubby end of the market. It puts people off."

LPs were fairly harmonious about the barriers to entry: track record and team experience were paramount. They value consistency and dependability above all, which places a significant premium of the longevity of team relationships. “It’s about being able to demonstrate over a long period of time that they have done the deals. People who haven’t been around for a long time are going to have a tough time raising money.” “The main barrier to entry is the quality of people. A lot of them talk a good game but not many do it.”

▲ Experience is the biggest barrier to entry.

Some LPs, however, expressed frustration that investors were placing too much weight on experience as a crude hedge against risk and thereby missing out on more promising opportunities. “What’s happening is that the whole nature of fundraising has been changing. If you have a recognised brand you can raise the money. There really isn’t that much in it. The whole dynamic of private equity is changing because investors aren’t really prepared to take risks. They want to invest in blue chips,” said one. Another offered a similar perspective from the opposite direction. “People with access to capital can get into the market too easily. If you have a well known name behind you and some good institutional clients then you can get up and running.”

7. COMPOSITION OF THE UK MID-MARKET TEAMS

▲ The composition of teams has been gradually changing.

The composition of UK mid-market teams is still heavily weighted in favour of accountants but one of the trends of the last few years has been an adjustment to that balance. Firms have been recruiting from a range of sectors to diversify their skill sets and there has been a particular emphasis on operational skills. Succession issues are also beginning to impact recruitment, with affected firms working hard to import fresh blood. The aggregate effect of these changes, coupled with the growing demands of the investment process, has been to encourage an increase in the average size of teams.

Team size

The average UK mid-market firm has 14 investment professionals. There was a range of sizes represented among the sample, from four at the bottom to 28 at the top. The size was clearly correlated to the segment of the mid-market in which the firm was active. All of the firms demonstrated a significant accumulation of private equity experience, with the average firm claiming about 120 man years in the industry. That meant the average investment professional had been in private equity for about nine years.

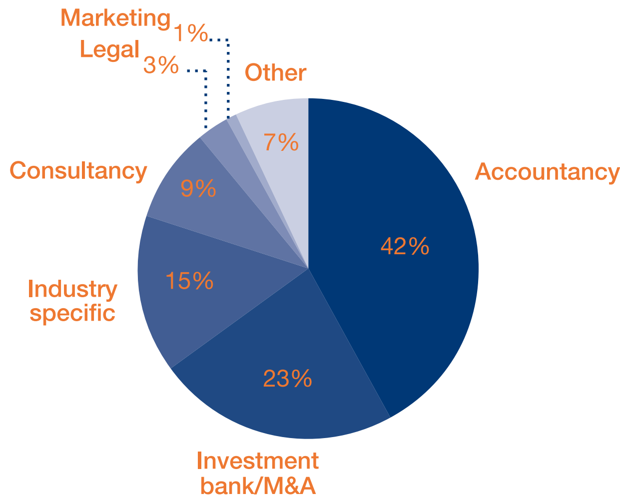
▲ UK mid-market teams typically contain a lot of experience.

Over half of GPs said they had grown their teams over the past five years and they offered a variety of reasons. Sometimes the larger team was simply a function of the fact that doing deals had become more time consuming than in the past. “We haven’t changed the balance of the team but we have grown the bottom of our pyramid. We have gone from one person on a deal ten years ago to two maybe seven years ago, to three or four nowadays. Deals are more complicated than they used to be.” Others had been responding to the need to prepare the firm for the departure of founders. “We deliberately wanted to grow for succession reasons. It is about achieving critical mass, depth and stability. Over the last five years we have been putting in place the structure.”

LPs said they were not prescriptive about the size of firms but they did not like to see investment professionals being overstretched. That meant they were more inclined to offer a minimum size than a maximum. “I like to see at least three partners and maybe seven or eight professionals. Any smaller and it is very difficult. This is a pretty hands on business. I don’t mind if the teams are larger. There is a minimum but no maximum.” Some, however, felt that firms sacrificed some quality when the teams became too large. “I like teams with about five or six senior partners so they have the ability to interact on a daily basis,” said one LP. “The best team is one that’s got maybe three to five partners supported by the same number of juniors. If teams get too big then they become volume driven rather than specific deal driven,” said another.

Professional experience

Figure 14. AVERAGE COMPOSITION OF UK MID-MARKET TEAMS



Source: AltAssets Research

A background in accountancy remains the traditional apprenticeship for mid-market practitioners. Figure 14 shows that some 42 per cent of the average team has a training in accountancy, followed by 23 per cent in investment banking or M&A, and 15 per cent in industry. "Accountancy is probably the best university for the mid-market. It's not perfect but the facility with numbers is always useful," said one GP. "There are a lot accountants in the UK mid-market. They effectively started the industry and they have the sort of skill set that is often required to do the job. Never underestimate the value of accountants," said another.

▲ Accountants still dominate the UK mid-market.

Investment bankers and M&A specialists are generally more recent to the industry, as are industry professionals. The other backgrounds are generally considered to be of secondary value as part of the team because they can be brought in as required. "We don't need legal expertise because we don't do big syndications. We don't do much market research besides speaking to the customers. And we can buy in the sort of consulting skills you would get from hiring a consultant. They are all things that are much more important at large buy-out houses," said one GP.

Mid-market firms have been trying conspicuously to bring in more industry expertise to help support their ambition to improve the operational performance of their portfolio companies. They expect that trend to continue. "We think there will be a little more weighting towards industry over the next few years," said one GP. They say, however, that it is not always easy to integrate those skills into a team that has historically been almost exclusively financial in its perspective. They typically either build them into portfolio management teams or have them on tap as part of an advisory board. "There are definitely more people from industry making their way into the business, either as part of the team or as attached advisors."

Figure 15. LPs' PREFERRED PROFESSIONAL EXPERIENCES

Rank	Preferred experience
1	Industry specific
2	Consultancy
3	Accountancy
4	Investment bank/M&A
5	Marketing
6	Legal
7	Other

Source: AltAssets Research

▲ LPs like to see a broad skill base.

LPs like to see a wide array of skills represented in a team and welcome the fact that they have generally become more diverse. "The teams have definitely got more varied in their composition in recent years." Figure 15 shows that the most highly regarded skills in the present environment are industry specific, consultancy, and accountancy. LPs are generally enthusiastic about the growing popularity of industry professionals. "There are a few more industry people in the teams these days and I think that will continue as the asset class assumes a higher profile. It becomes easier to attract them into the game and they will produce some benefits in terms of the range of skill sets," said one investor.

The underlying motive has been the recognition that growing businesses in a weaker economic environment requires a different set of experiences from the sort that have featured most heavily among teams in the more effervescent past. "We are starting to see teams trying to do things differently but it is slow happening. People have begun to realise that private equity is about business building as opposed to financing. The focus is on building and that is almost a new concept for a lot of people in private equity."

Some LPs would also like to see the professions that have historically been fairly peripheral to private equity more extensively represented in the future. They feel that the operating environment of the next few years is going to demand a radically different approach from the past. "Marketing skills are going to become increasingly important as an additional element. There are still too many accountants and it is still considered too much of a numbers game. You really want people who have a feel for business but too many houses still think of this as being a purely financial exercise."

Although efforts to improve the operational capability of mid-market teams are generally lauded, there is some low level scepticism about its usefulness. "We're not completely sold on the idea of having operational people on board. I don't see why there is an immediate assumption that operational people will add a lot of value." Some LPs are also concerned that it is more difficult to achieve than GPs like to suggest. "Everyone thinks they need more industry experience because of this new premium on improving operational performance. But recruiting from industry is quite difficult. There are important cultural issues with industry professionals."

And some LPs are worried that UK mid-market firms have systematically failed to refresh their skills under the misapprehension that it was getting more sophisticated. "My biggest concern is that the industry has dumbed down and professionalised upwards. It is full of qualifications but there is hardly any real operating experience....The industry has failed to keep its genetic diversity up to date. Some of the same firms are there but the quality of personnel is not what it was. It may also be that the size of teams mitigates against constant renewal. There just isn't that much turnover."

8. EXITS IN THE UK MID-MARKET

▲ Recent years have seen a deterioration in exit conditions.

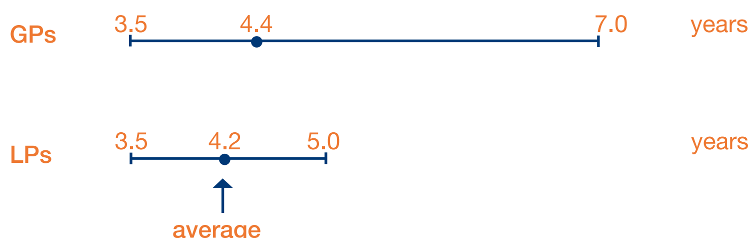
Exit conditions have deteriorated dramatically over the last three years. IPOs are now almost pure fantasy and trade buyers have largely retreated to take care of bruised balance sheets. One of the most conspicuous effects has been in the extension of holding periods. Firms have found themselves holding onto portfolio companies for longer than planned, although most feel this represents a return to more normal conditions than the unusually abbreviated investment cycle of the late 1990s. The other important development has been a big increase in the number of secondary buy-outs. GPs think this latter development is more structural than cyclical and argue that it reflects a more mature industry. LPs are less convinced.

A very different set of exit conditions

The collapse in public markets, precipitated by the implosion of the technology bubble, has had a profound albeit indirect effect on the UK mid-market. IPOs had not been a critical exit channel for some time - mid-market portfolio companies were often too small to be listed - but the fall in public equities was extremely damaging to the legion of trade buyers that provided the principle exit channel. They turned in on themselves to repair balance sheets and weather the increasingly hostile economic conditions. The main effect has been the absence of exit opportunities, which in turn has resulted in longer holding periods, a rash of secondary buy-outs, and the growing popularity of recapitalisations.

Holding periods

Figure 16. GP AND LP EXIT EXPECTATIONS



Source: AltAssets Research

▲ GPs say holding periods are now more typical.

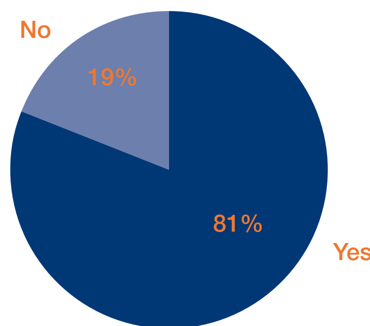
Holding periods have changed and changed again. GPs' judgment about the present length depends on their chosen time frame. Some think they are getting back to normal, saying the late 1990s were atypical. "The holding period came down during the 1990s and you saw a fair number of quick flips but it is stretching out again now to something more like the holding periods you saw in the 1980s." Others think they are still a lot shorter than historically, using the late 1980s and the early 1990s as their comparator. "Holding periods are getting shorter when you compare them with ten years ago." On average, GPs expect to hold onto their portfolio companies for a little over four years but their predictions range from three and a half years to as long as seven. (See figure 16.)

LPs generally feel that holding periods have stretched in the last few years as a result of the downturn in public markets but they are also more accusatory than the GPs. They feel it is not just about the deterioration in exit conditions but that the problem stems from a lot of GPs having overpaid for assets at the top of the cycle. "The problem has been that people paid too much at the top and don't want to sell at a loss. They have to keep riding the investment until the multiples come back. Holding periods are going to get longer as a result. They have already lengthened a bit but that was more about the scarcity of exit opportunities."

LPs think about four years is a reasonable holding period and offered a much shorter acceptable range of between three and a half and five years. "We like to be able to reinvest and that means we want money back. We think three to five years is a perfectly reasonable length of time," said one LP. Some said they were prepared to be more patient if the fullness of the holding period was productive. "I don't mind how long they hold onto a portfolio company as long as they are adding or maintaining value."

Secondary buy-outs

Figure 17. GPs EXPECTING SECONDARY BUY-OUTS TO REMAIN AN IMPORTANT FEATURE OF THE MID-MARKET



Source: AltAssets Research

A large majority of GPs think secondary buy-outs, the sale of an asset from one private equity firm to another, have become an important and positive feature of the mid-market. (See figure 17.) They usually stipulate the need to look at each occasion in its own right but say that there should no longer be any stigma attached to secondaries or reason to object philosophically. "Some people seem to have a religious objection to secondary buy-outs but that's just rubbish. You have to look at it on a case-by-case basis," said one GP. "The stigma of secondary buy-outs is probably gone and I think that people realise it's happening now for investment reasons," said another.

▲ GPs generally think secondary buy-outs are positive.

It is the loss of inhibition and the recognition that they represent a valuable source of liquidity in a difficult exit environment that have combined to make secondaries a much more significant part of the industry. "What has changed is the willingness of people to participate. The private equity industry has grown and of course people are looking for exits. Certainly it's a natural evolution in the market. There are good things and bad things about it but our experience has been positive," said one GP.

This natural evolution, the idea that secondaries represent a formalisation of some sort of private equity food chain, is one of the central planks of the argument in their favour. "Secondary buy-outs have and will continue to be more important. The reason is simple. Private equity owns more of the economy than it used to. It is inevitable that there will be more buying and selling between firms," said one GP. "There is a food chain emerging in the industry and that is reflected in the growth of secondary buy-outs. If you're buying firms with an enterprise value of £20 million to £30 million and growing them to about £50 million to £60 million then that is the perfect size for the bigger end of the market. Secondary buy-outs are a great exit stream for operators at the lower end of the mid-market," said another. One GP operating at the lower end said larger private equity firms were now so well capitalised that they were now "effectively what the small cap of the public markets used to be."

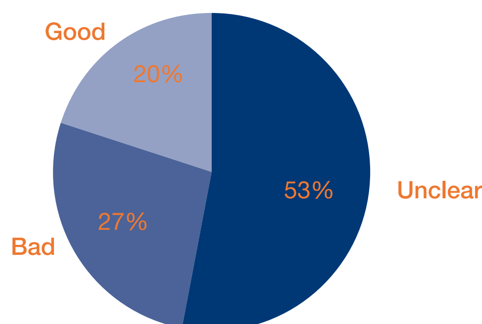
▲ GPs say secondary buy-outs represent a more mature industry.

Some GPs were vociferous in their defence of secondary buy-outs and expressed frustration at what they considered simplistic analysis of the way they had grown in significance. "Corporates buy from corporates. I don't see why private equity firms shouldn't buy from other private equity firms. The reason is that private equity firms have a time horizon of up to five years and a lot can happen in that time. A company can change dramatically. Some of our investments, for example, simply got too big for us but they weren't too big for other private equity players and it made sense for them to shepherd them through to the next stage in their evolution."

There are, however, some sceptics among the GPs, who feel that competitors use secondaries simply to generate liquidity in advance of fundraising or because they are desperate to invest. "There are a lot of private equity houses that need exits so they can get back out fundraising. And there is a pool of houses that have money they need to deploy." Others simply question the extent to which there is likely to be any growth potential left in a business once a private equity investor has decided to pass it on. "We tend to avoid them (secondaries) unless there is a specific angle. We need to be persuaded that there is a proper story before we'll get involved. We don't like to leave too much on the plate."

The sceptics tend to perceive the popularity of secondaries as a function of the cycle and predict they will fall back significantly when exit conditions improve. "We're a bit cynical. You're really just churning the portfolio for investors. It does represent a bit of liquidity and that is not necessarily a bad thing. But as an industry at large we are not making money for ourselves by recycling investments. To get real value out of the market you have to find a trade buyer. He's the one that will pay a premium."

Figure 18. LPs' VIEWS ABOUT SECONDARY BUY-OUTS



Source: AltAssets Research

Just over half of LPs are unclear or undecided on the merits of secondary buy-outs. Some 27 per cent think they are an unwelcome development and 20 per cent think they are positive. (See figure 18.) Their judgment depends largely on their position in the transaction and only time and sufficient comparable data will solidify their views one way or the other. They are also less persuaded than GPs that secondaries will remain as important once market conditions improve. "I have really mixed feelings about secondary buy-outs. I don't care about them when I'm a seller but I really don't like to be at the buying end. They are characteristic of a maturing industry and the cyclical problem of a lack of exits. You won't see so many when strategic buyers come back."

▲ LPs are less clear about the benefits.

Those in favour of secondaries base their enthusiasm on the emergence of the so-called private equity food chain and the view that the industry as a whole is becoming more sophisticated. "Secondary buy-outs have been a perfectly rational development. Smaller funds can do a certain amount and then they want to pass it on to someone larger after a few years. It shows the industry is maturing. I don't think there is anything wrong." Some have also been persuaded by experience. "We have seen successful secondary buy-outs and a number of groups have proved they can make them work. The argument that you can't make money out of them is not valid and on balance we like them."

Other LPs, however, are still not convinced that the small-to-large-buyer model explains the majority of secondary transactions. "I don't mind a secondary buy-out if it is about selling from a small group to a larger one. That way it is about the buyer doing something with the business that the smaller firm wouldn't have been able to do. But I don't like seeing investments being recycled. I think the majority is recycling and it often seems to happen just before a firm starts fundraising. We really haven't seen too many cases of the other kind in our portfolio." Their suspicion is that GPs' enthusiasm is sometimes genuine but also a function of wanting to make them seem an acceptable option at a time when there are very few alternatives. "I would hope that secondary buy-outs will moderate but in reality I am worried that GPs have discovered an easy way out."

9. DIFFERENTIATION IN THE UK MID-MARKET

There is not a high degree of differentiation in the UK mid-market but there is a growing recognition of how important it has and will become. The first manifestation of that realisation has been the prevalence of intermediary-facing marketing efforts. That is now commonplace. A handful of firms have also begun thinking in detail about how to embed themselves in the consciousness of institutional investors, their long-term sources of capital. There is a clear understanding that the competition for that capital is set to intensify in the years ahead. The starting point has been the formalisation of the investor relations function at a lot of firms, sometimes more to the frustration than welcome of LPs.

▲ UK mid-market firms are now more determined to differentiate themselves.

These efforts, however, are still generally formative at best. LPs said UK mid-market teams do not differentiate themselves with great effectiveness. There is something positive in the fact that there is not an immediate differentiation along the lines of perceived quality. They are all judged to be similar. It also signals that some of the usual discriminators, such as the age of the team and their collective experience, are almost commodities in the UK mid-market. But it also suggests a need for some profound thinking on the part of GPs about how they can acquire a larger share of the institutional mind going forward. They will need to muscle their way in front not just of local competitors for capital but also ahead of the other maturing markets. Describing themselves as mid-market has, until relatively recently, been differentiation enough but now almost everyone is doing it.

Differentiating characteristics

GPs have been putting considerable effort into marketing themselves to intermediaries in recent years, once again reflecting the importance of an efficient deal sourcing process. They have not generally thought in detail about marketing themselves to the LP community. "In terms of the LP end of the microscope, I would guess they are hearing the same sort of story; proprietary deal flow and track record," said one GP. "Most firms haven't thought about how to be distinctive. It's difficult to say how we differentiate ourselves," said another.

Part of this shortcoming reflects the fact that a significant proportion of the UK mid-market population was until recently captive or semi-captive and not required to think so seriously about the source of their capital. Part of it stems from the fact that fundraising had been easier until the last couple of years. And some of it can be blamed on naivety. "There is this incredible belief that if you are a strong enough personality you are going to make an impact in the market."

The result is that GPs often unwittingly produce a lot of glibness when they try to express how they are different from the competition. "We are just not part of the crowd. We don't just pitch up at an auction and outbid everyone." "We have a record of making good investments." "We are independent in thought and process." None of these things are likely to register with LPs, who typically see a large slice of the entire mid-market population in some form or other over the course of a couple of years. The failure among GPs to appreciate that they are part of a large parade in front of the LPs belies their historical lack of seriousness about the need to differentiate. LPs often remark that they think GPs do not realise they are saying the same thing as everyone else.

Figure 19. MOST IMPORTANT DIFFERENTIATING CHARACTERISTICS OF UK MID-MARKET FIRMS

GPs' views

Rank	Characteristic
1	Team and experience
2	Sector focus
3	Network
4	Track record
5	Operational managers

LPs' views

Rank	Characteristic
1	Track record
2	Team and experience
3	Operational managers
4	Sector focus
5	Network

Source: AltAssets Research

GPs think that the most important differentiating characteristics among UK mid-market firms are the team and its experience, sector focus, network, track record and access to operational managers, in that order. (See figure 19.) Some of the outlying differentiating characteristics included consistency, the capacity to transact on deals quickly, and not engaging in price-chipping once a bid had been tabled.

LPs said it was not easy to differentiate among UK mid-market firms. "They like to say they are operationally different. They talk about sector focus. And they stress their proprietary deal flow. Sometimes they are not as clear in enunciating their differences as we would like. It is difficult to differentiate in the UK mid-market. When you look at this space they are relatively similar businesses with relatively similar people," said one LP. "We have invested in 15 to 20 funds and if you ask me what have been the key differentiators I would find it hard to say," said another.

They did, however, agree with GPs about the most important characteristics, albeit with slightly different priorities. "Track record is the most important thing but that is usually in a pretty narrow range." "We mainly look at longevity, track record, and industrial experience." "We differentiate firms by looking at evidence of what they have done in the past and how their strategy has evolved." "Team stability and experience are the most important things."

LP dislikes

Figure 20. MAIN LP DISLIKES

- Strategy shifts
- Team instability
- Jump in fund size
- Extravagance

Source: AltAssets Research

▲ LPs dislike any sign of drift.

LPs generally expressed high regard for UK mid-market firms, chiefly because they recognised that most of them had been around for a long time. There were, however, some actions and characteristics that they described as being immediately off-putting when they were analysing investment opportunities. The first of those was evidence of strategy shift, followed by team instability, big increases in fund size, and extravagance among the GPs. (See figure 20.) "We don't like strategy drift, either size of deals or sector. We don't really like fund size shift either, when firms raise a much bigger fund than their previous one," said one LP. "The thing we don't like to see is people walking away from the firm. That means we have to take a good look at the incentives that are in place," said another.

Some of the LPs expressed weariness about discipline bred of recent experience. "Three years ago we didn't want to see our managers doing technology deals but they did it. I don't like seeing firms closing their regional offices but everyone seems to be moving away from what they had. I don't really like sector specialisation. And I really don't like changing focus and a failure to keep teams fresh." And others said they resented the way broader changes throughout the private equity industry had affected the mid-market firms. "We don't like to see their funds under management growing too fast. It just means the incentive moves from carried interest to management fees. We don't like plush offices. We don't like it when all the work is done by junior members without much input from the senior partners. And we don't like overweening arrogance."

Investor relations

Investor relations have become much more important over the last few years. GPs understand that fundraising conditions are much more unforgiving than in the past. They expect LPs to reduce the number of GP relationships they currently maintain, which foreshadows an intensification in the competition for capital. And they observe that investors have become more sophisticated and demanding in recent years. Mid-market firms have also been impacted by a trend across the asset class as a whole towards a major improvement in the way they maintain their investor relationships. That means more transparency, higher reporting standards, and greater consistency.

This broad development has been accompanied in the mid-market by a fall in the number of captives, thrusting a different and more burdensome client responsibility on the spin-outs. Having addressed the issue of establishing their new identity in the minds of the intermediaries, institutional investors are the next major targets. The effect is rubbing off across mid-market firms as a whole, often importing an investment banking approach to investor relations that was previously alien to the sector.

"Investor relations has become much more important. It is a function of the level of sophistication now among investors. You really need to be sure you are effectively communicating your strategy," said one GP. Another stressed the growing appreciation of the need to develop long-term relationships with LPs. "The industry has matured and now it is all about developing long-term relationships with your sources of capital. These guys are your customers and it definitely requires a dedicated resource."

This idea that the emerging significance of investor relations was another natural evolution in the industry was commonplace. "Fifteen or 20 years ago we all left 3i and we were deal junkies. What we did was deals. Then someone realised that you could sell that to investors. We raised the money and then didn't talk to them for five years. Then we'd go back and ask for more. Now we've become professional fund managers."

There was consistent rejection across the GPs that the increasing prominence of investor relations was a reaction to frustration among LPs that they had historically been denied enough information about the activities of the fund managers. "It's not true to say that investors don't get the information. As an industry at large we have got quite good about reporting. Over the last ten years we've gone from raising money from ten or 15 institutions to building international marketing teams. Our investors are buried in information. The industry is probably over reported."

Despite this evolving sophistication about investor relations, GPs were deeply divided about the relevance of the concept of brand. They were comfortable with brand as far as it informs the way they present themselves to the sources of deal flow but they were mixed about the extent to which it could supplant the preeminence of track record as the ultimate definition of a firm's attractiveness. Some thought it would become increasingly important. "I think this is a big area of change for the private equity industry. Brand is becoming much more important in the mid-market and the large buy-out market. Brands are emerging. There are a cluster of firms that stand out and in uncertain times investors will go for what they know," said one GP. Others were less convinced. "Brand is nothing more than the team of people and most investors and vendors will look through that to the underlying level," said one. "I don't think it is relevant to fundraising. Investors are too wise for that. They probe into all the details," said another.

The LP perspective on investor relations

▲ LPs say investor relations have improved.

LPs generally agree that investor relations have improved over recent years. Sometimes that simply reflects an increase in the quantity of information they receive. "They all send out newsletters and deal sheets and information out to the market, to prospective investors as well as existing LPs. There is definitely a more sophisticated approach." Sometimes they say that GPs are more responsive to enquiries or more sensitive to the fact that LPs want to hear information about their investments well in advance of the market at large.

Some LPs, however, feel that investor relations have in fact got worse in recent years despite the increased attention it receives from GPs. "Investor relations have totally deteriorated over the last few years. Part of the so-called professionalisation of the industry is that there are all these so-called client liaison people. They don't make it easier. They act as a barrier. The people on whom you make your investment decision are the people doing the investing. But you can't get near them nowadays. The introduction of client liaison people has been handled very badly. You can't get to speak to the people you want to. They have polished up the image and you can't get a frank discussion any more."

As for brand, LPs were largely sceptical about its usefulness but suggested it must exist in some form to explain what they considered anomalous fundraising successes. "Some people seem to have been able to raise a lot of money and I haven't been able to work out why so there must be something to brand. It can only be that some people just look at the name."

10. COMPARING THE UK MID-MARKET WITH CONTINENTAL EUROPE AND THE OUTLOOK FOR THE FUTURE

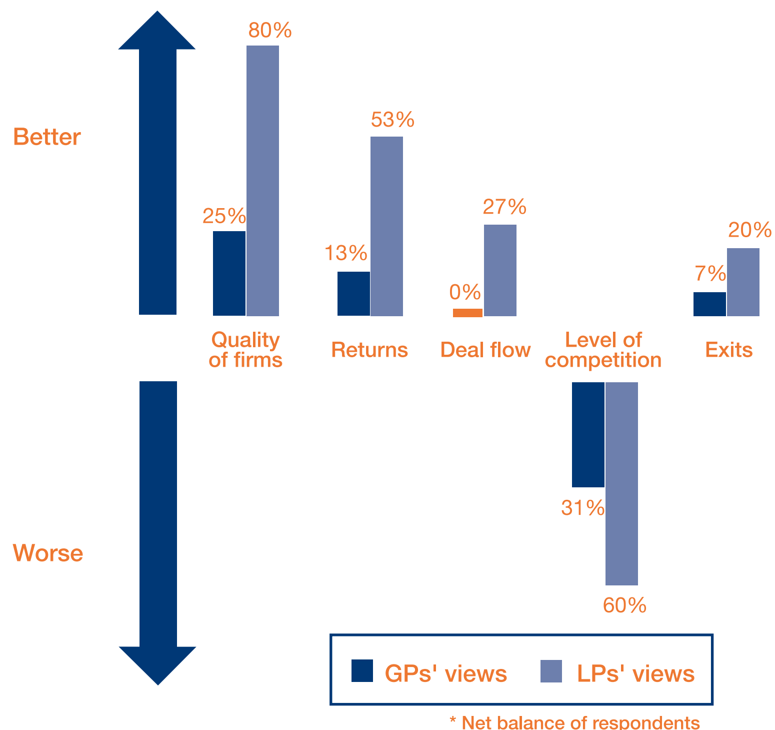
▲ UK mid-market firms are generally well regarded.

The UK mid-market compares favourably with the continental European mid-market. GPs stress the extent to which the operating environment is more supportive for private equity firms, both culturally and legislatively. LPs emphasise the depth of quality among the UK mid-market firms and their track record for generating decent returns. The balance of both LPs and GPs say the UK is more competitive than continental Europe, although analysis shows that the ratio of deals per mid-market buy-out firm in the UK is higher than in any of the major continental European mid-markets, which suggests the contrary to be true. Despite this endorsement, however, most LPs say the continental European mid-market is rapidly maturing and the gap between the two regions will continue to narrow.

Looking ahead, conditions for exiting and for making investments are expected to improve. Returns will suffer in the medium term from the hangover of investments made at the top of the cycle but they will continue to look attractive on a relative basis. Competition is expected to remain intense but the volume of deal flow should accelerate. The consensus among both LPs and GPs was that there would be some gentle change in the market over the medium term but that one of the UK mid-market's chief virtues, its dependability, would remain unthreatened.

Comparisons with the continental European mid-market

Figure 21. HOW THE UK MID-MARKET COMPARES WITH CONTINENTAL EUROPE*



Source: AltAssets Research

GPs are fairly reticent about comparing themselves to their continental European counterparts. The prevailing view, however, was that there was a greater depth of quality of teams in the UK, if only because the market was more mature and benefited from more experienced participants. "UK firms are better than their continental European counterparts but that is a function of their maturity. UK mid-market performance has been more stable. If you invest in Europe you need to be very selective about the teams you back," said one GP. "The difference between the UK and continental Europe comes down to the cumulative experience of the market. But I wouldn't be complacent. There are a lot of good people on the continent," said another.

▲ GPs say the UK is an easier place to invest than continential Europe.

Most GPs also felt that the economic, fiscal, and cultural conditions in the UK were much more sympathetic to private equity investing than in continental Europe. "There are more banks in the UK, the tax system is better, capital gains tax is lower, the legal environment is more sympathetic, and the quality of accounting is better in the mid-market. There may be more entrepreneurs in Europe, just because there are still a lot more family businesses, but there are far more quality managers in the UK," said one GP. "Generally speaking the UK mid-market is much more developed. It's an acceptable thing to do here. The cultural differences are very very important," said another.

Although on balance GPs thought the UK mid-market was more competitive, some strongly disagreed and argued that the ratio of deal flow to participants was more favourable in the UK. (See figure 22.) "The UK mid-market accounts for about half the mid-market deals across Europe every year but has half the number of players. There are twice as many players in continental Europe attacking roughly the same number of opportunities," said one GP. "It is not so centralised in continental Europe so it is not so efficient. That also means that it isn't quite so ruthless but there is probably no less competition, it is just slightly different in style," said another.

▲ LPs say the gap between UK and continential European firms is narrowing.

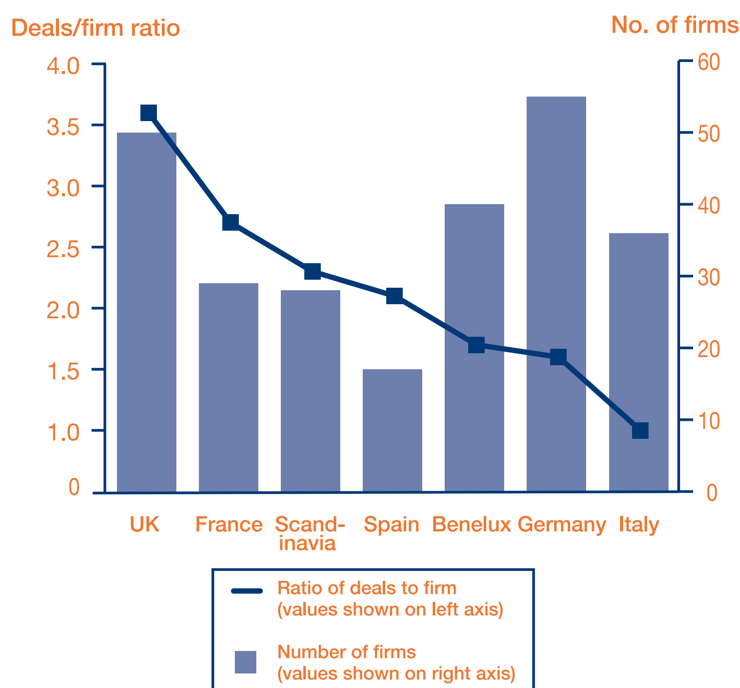
LPs were more emphatic in their judgment that the overall quality of firms in the UK mid-market was higher than in continental Europe, although they made the same observations about the gap narrowing. "The average team quality in the UK is probably better than in continental Europe but the best continental teams are often better nowadays than in the UK. Similarly the opportunity for higher returns is sometimes better now than in the UK." But some LPs stressed the significance of the depth of quality in the UK. "If the UK mid-market has an outstanding virtue it is that you won't find a nasty surprise by investing there. It is mature, sophisticated and professional."

The balance of LPs thought the UK mid-market was more competitive than continental Europe but said the gap was closing and in some respects they were comparable. "Everybody thinks that because the UK is a sophisticated market place it is competitive but that is not necessarily the case. Markets like France are probably more competitive and Scandinavia is under a huge amount of money," said one LP. "The UK used to be more competitive than continental Europe but in some places it is now pretty similar," said another.

They also generally agreed with GPs that the operating environment in the UK was more supportive for private equity than many parts of continental Europe. "You can have greater influence over UK companies by holding board seats. There is a more sympathetic corporate governance culture for buy-out firms. The fiscal problems are also much worse in continental Europe. There is more understanding of management in the UK," said one LP. The result, some LPs said, was that the UK mid-market remained an attractive destination for their capital, despite the fact that it was a mature, reasonably efficient, and competitive market. "It (the UK) still compares very well with continental Europe and I don't see any other market getting close to having the pieces to beat the UK for the foreseeable future."

Comparing competition in the UK and continental European mid-markets

Figure 22. THE RATIO OF DEALS TO FIRMS IN THE EUROPEAN MID-MARKETS



Source: AltAssets Research, BVCA, EVCA

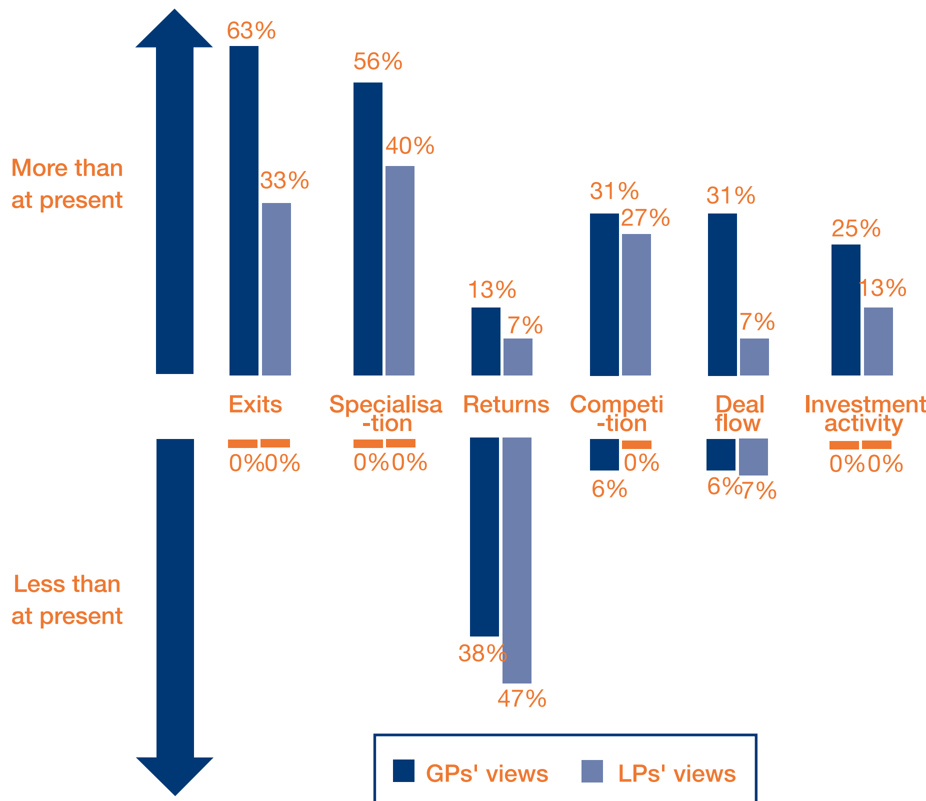
▲ The UK mid-market is not as competitive as continental Europe on some measures.

On balance, GPs and LPs said they thought the UK mid-market was more competitive than the continental European mid-markets. That judgment largely belies the number of firms that are active in the UK compared with the number in the individual continental mid-markets, with some adjustment made for a rough calculation about opportunity. The reality, however, is different and a more accurate measure of competition puts the UK in a more encouraging light. Figure 22 shows that the UK enjoys the highest ratio of deals to buy-out firms among the major European mid-markets. In other words, although there are more firms in the UK than almost any other market, there are also a lot more deals to share around those firms.

There are approximately 50 firms active in the UK mid-market, completing nearly 180 buy-out and buy-in deals in 2002. That produced a ratio of almost four deals per firm. (That also matches the average number of deals per annum among the GPs that participated in this research.) The average in France is just below three, in Scandinavia a little about two and in Italy it is only one. This may only be a partial measure of competition - it makes no allowance for the quality or size of deals, for example - but it is a clear indicator that the UK mid-market is not as competitive as the size of its population would suggest.

The future outlook for the UK mid-market

Figure 23. EXPECTED DEVELOPMENTS IN THE UK MID-MARKET OVER THE NEXT FIVE YEARS



Source: AltAssets Research

Neither LPs nor GPs are expecting major changes in the UK mid-market over the next few years. Such is its welcome predictability. Exit conditions are expected to improve, deal flow might pick up a little, and investment activity should accelerate. (See figure 23.) Returns will remain under pressure from the enduring effects of the public market downturn and competition might intensify. The only major structural changes are expected to be the continuation of the trend towards greater sector specialisation and, almost hand in hand, a clearer stratification in the mid-market as a whole.

▲ The UK mid-market is not expected to undergo big changes over the medium term.

"I think there will be more specialisation but it will be more about the segment of the mid-market than industry sectors. I think investors are going to want their managers to stick to what they know," said one GP. "We think there will be ever more stratification in the market. The dynamics of doing deals at the top end of the mid-market and the bottom are very different and will become ever more so," said another. The effect will be more sector focus in the upper mid-market and a greater conspicuousness about generalism in the lower part.

▲ Tough fundraising conditions are the main worry for GPs.

Despite this relative stability, GPs are looking ahead with a mild sense of foreboding. There is a recognition that fundraising conditions will remain difficult for the foreseeable future and that this will affect the survival prospects for some firms. "Over the last few years the LPs have definitely seen that the good days have disappeared. There has been a lot of reassessment of what they put their money into and a lot of them are very annoyed with the groups that raised money on one pretext and invested on another. It has become a lot harder to raise money," said one GP.

The effect may well be some shrinkage in the number of firms in the market. "I would expect a degree of consolidation. Investors are looking for fewer GP relationships and there will eventually be fewer people with decent sized funds." Even if disillusionment is not the main driver, there will be serious competition for the available capital. "We think there will be some contraction in the market just driven by fundraising. If the large investors are overstretched or overallocated then there will be fewer funds out there." And the pain may be felt by even the most experienced firms. "I think there might be a bit of shake out and some of the old names disappearing."

The effect of this reduction in capital has been rolling its way across the private equity industry, starting nearest the source of the technology bubble but making its way steadily across the risk spectrum. Mid-market buy-out firms have been benefiting from the move away from early stage investing, emerging markets, and even some large buy-outs. The mid-market profited from the perception of it being safer: the underlying theory being that it enjoyed more reliable deal flow, it was more efficient, and there was less competition. And within the European mid-market, the UK was generally considered the most dependable market. Remarkable for being unremarkable. But even the UK mid-market will not be spared the squeeze on capital as the excesses of the 1990s boom continue to unwind.

APPENDIX

- The report was based on interviews with 16 UK general partners (GPs), private equity mid-market fund managers, and 15 limited partners (LPs), institutional investors in mid-market private equity funds. All the interviews were conducted during August and September 2003.
- Respondents participated on the basis on anonymity.
- All the LPs had extensive experience of investing in the UK mid-market and had invested in an average of eleven different funds in the region.
- On average, the UK mid-market firms dated their activity back to 1988. Half of the respondents invested solely in the UK, while the other half was also active in some continental European markets.

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