Synopsis: Opportunities in the mid-market buyout market in Europe

Over recent years, the spectacular growth of the European buy-out market has made it a regular feature of press headlines. 2005 was a particularly strong year, breaking a number of records: European funds raised reached € 60 billion; the value of investments in Europe hit € 124 billion, topping € 100 billion for the first time and Europe saw its first deal in excess of €10bn. 2006 has continued this trend with the news of KKR's IPO on the Euronext and the advent of the first € 10 billion fund. While press headlines have tended to focus on the top end of the market, reporting on the ever-larger "mega-deals" such as the buy-outs of Hertz and TDC, the European mid-market (deals < € 250 million enterprise value) has remained relatively low profile.

Nevertheless, in 2005 as in previous years, the mid-market remained by far the most active segment of the market, accounting for 92% of all European buy-out deals. In all, the mid-market represented 1,253 out of the total 1,357 deals closed. At the same time, in terms of value, this segment represented only about 22% of the total amount invested at approximately € 144 billion. The mid-market has demonstrated strong and consistent growth over recent years with activity levels rising by 3% p.a. since 1995 and with the total level of annual investments growing by 9% p.a. During this period the mid-market landscape has changed significantly as Continental Europe has become increasingly prominent, catching up rapidly with the UK, the historic power-house in Europe. In 2005, the Continental European markets almost overtook the UK for the first time in history in terms of the total number of deals completed.

An empirical study of 33 leading European Mid-Market Buy-Out Funds produced by the Private Equity Consultants FHP (Fleischhauer, Hoyer & Partner) in 2006 shows increased maturity in the sector, strong deal flow and lower risks going forward compared to the large buy-out market. The study concentrated on funds targeting the majority acquisition of companies valued below the 250 million Euro threshold:

Characteristics and key success factors

On average, mid-market fund mangers have existed for some 13 years and are managing their 3rd generation of funds, The most experienced fund manager surveyed had a forty-five year history. Each fund includes an average of 11 professionals, for the most part generalist. Total capital under management averages €522 million (across several generations of funds) with the average size of the most recent fund being €283 million.

European mid-market funds clearly focus on their core competencies – general buy-out transactions and situations. 82% of the funds surveyed describe themselves as buy-out specialists. The target companies are typically concentrated in the € 50 million to € 100 million value range – a focus on the classical mid-market. By contrast, there is no evidence that industry specialization has become the rule among mid-market funds – they tend to be more generalist than industry-dedicated funds, finding it easier to capture the broad range of opportunities across industries in the European market.

One of the most important differentiating factors compared with the large buy-out market is the strong single-country focus: 82% of mid-market managers surveyed described themselves as "national players". Correspondingly, their portfolios contain a high proportion of local deals – 76% of the funds even have an exclusively "local portfolio".

The mid-market offers considerable deal flow with fund managers screening an average of about 160 pertinent deals per year. This number has risen marginally (by 4% p.a.) and is expected to continue to increase in the future. Unlike the large buy-out segment, the primary source of deals is succession issues and sales by family owners. In 2005 close to 500 family owned businesses have been sold to Private Equity Funds, a 22% increase compared to 2004. Overall a third of all companies sold are now prior family owned businesses and represent the most important source of deal flow for Private Equity Funds in Europe.

Competitive dynamics and returns

While the mid-market is partly intermediated (48% of deal flow comes from intermediaries), other sources of deals (own network and proactive deal sourcing techniques) also play an important role. Proprietary deal flow has been and still is a key means of sourcing deals at a reasonable price. While intermediaries mainly come from the close circle (lawyers, auditors, advisors) of the local vendor, formal auctions are much less prevalent in the mid-market than in the large one with only 21% of fund managers surveyed participating regularly in what they regards as competitive auctions. Other differences from the large buy-out market are the lower levels of vendor diligence (14% of deals) and low levels of staple finance (5% of deals). In general, the mid-market is characterized by a lower level of institutionalization.

As family businesses and generation changes will be the key investment drivers for the future, access and close relationships with the local owners (sellers) will play a fundamental role in competitive bidding situations. 91% of the funds surveyed believe that building an intensive relationship with the management is a key differentiating factor. Mid-market funds display specific skill sets enabling them to work with local small and mid-sized companies often run by family owners, and to convince their owners and managers of the appeal of private equity as a liquidity solution.

Mid-market funds will add value primarily by providing portfolio companies with operational and strategic support – much less importance is given to pure financial engineering, which is becoming more and more a commodity. As demonstrated by our empirical analysis, the mid-market buy-out funds have shown a lower average level of leverage. In most cases, mid-market funds take majority position– on average an equity stake of about 70%. This level of control provides managers with the ability to implement strategic and operational change within their portfolio companies, improving profitability at a company level and creating value for their investors.

Operational experience will be required to an increasing extent for driving future returns – the corresponding level of experience among general partners will be a pre-condition for successful mid-market funds. On a company level, these opportunities for growth, sector consolidation, improved operational leverage and improved management systems offer considerable return opportunities. This promise is reflected in the returns observed by the funds surveyed which averaged 2.76x for realized investments across all fund generations. At the extremes, the realized performance (excluding unrealized investments) of individual funds ranged from 1.3x to 7.0x. This level of returns is generally seen as being sustainable in the future. Fund Managers surveyed forecast future net returns of about 25% IRR and 2.5x respectively – also promising despite a generally more competitive environment.

Outlook – key trends and challenges

There are almost 200,000 small and mid-sized companies with more than 25 million Euro revenues in Europe. The increasing acceptance of private equity as a source of capital and liquidity among entrepreneurs, family owners and large industrial groups creates a huge potential market for European mid-market Buy-out funds. The expected increasing deal flow will be driven by the financing needs of family businesses and generation change as well as the continuing industry consolidation in Europe. At the same time, there will be a more inviting environment for mid-market funds in Europe in the coming years. Private equity is expected to be increasingly accepted by company owners and management teams.

In future, more attention is expected to be paid to buy-and-build strategies and active ownership. Besides this, there will also be an increased focus on promising sectors like healthcare, services, and consumer goods. However, industry specialization is not expected to increase in future. The development potential is especially high in continental Europe, with countries like Spain, Germany, and France seen as being particularly attractive for mid-market deals in the next few years, according to our respondents. Despite a slight recent slow-down, the UK continues to offer attractive opportunities, especially in the smaller segment.

An improved exit climate, driven in part by increased secondary activity, will continue to play an increasingly important role – and large caps (mega funds > € 1 billion) will be seen increasingly on the buyers' side. Nevertheless, trade sales will remain the most common and preferred exit channel. The roadmap in numbers is promising: A full exit pipeline of about 210 companies is expected to be realized within the next three years. At the same time, secondary buy-outs have established themselves as a permanent feature of the market and are expected to continue to provide quality deal-flow.

The key risks are believed to be linked to deal pricing and increasing competition on a deal–by-deal basis. Although valuations in the mid-market remain significantly lower than at the larger end, some concerns and price pressure exist, especially at the higher end of the deal spectrum. Despite increasing competition, there are still plenty of proprietary characteristics. This offers more potential for differentiating strategies between fund managers and, consequently, more scope for transforming portfolio companies into successful exit candidates.

Whilst the earlier years of a mid-market manager's existence were frequently characterized by rapid growth in fund size, with funds growing by about 60% from one generation to the next, our findings show that this is now beginning to stabilize. On average, the fund managers surveyed forecast a moderate increase of about 20% over the current fund size for their next fund generation – the average fund size is expected to be relatively stable at approx. € 340 million. This does not represent a buoyant increase compared to the current fund size – this in turn limits the risk of investment drift. Whilst the fundraising boom witnessed in 2005 is due to continue with 22 out of 33 fund managers surveyed conducting fundraising in 2006 and 2007, access to the best mid-market funds is expected to become an issue for investors. To conclude, the mid-market is a segment, which has not been in the public eye much until now, but it looks set to become one of the hot spots in the European private equity arena.

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