A PEI supplement

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The growing appeal of mid-market private equity

In an environment where mega-funds are losing favour in the LP community, Capital Dynamics continues to see great opportunities in the mid-market.

Although it is headquartered in Switzerland, Capital Dynamics has a global presence and a 20 year track record of investing in the US. Recently, the firm narrowed the strategy of its core US fund of funds to be solely mid-market and it has created separate funds for niche strategies such as venture capital.

“What we’ve heard from our LPs is they want a more focused approach, and so now we have more of an à la carte menu,” says Andrew Bernstein, a director in Capital Dynamics’s investment management division.

“What we’ve seen since the Lehman collapse is that the large mega-cap firms actually have not fared as well as mid-market managers,” says Cynthia Duda, managing director in investment management at Capital Dynamics. “If you look over many different economic cycles, mid-market funds have had very nice steady performance, especially in this last credit recession because mid-market companies tend not to put on as much debt as large-cap companies.”

BUILDING VALUE

In the current climate, Capital Dynamics focuses on managers that take what it calls a ‘platform buy and build’ approach.

“We think from a risk-return standpoint that the platform buy and build sub-strategy is very attractive after a recession,” Duda says. “Small companies, which can be acquisition targets in a buy and build strategy, are often vulnerable after a recession and can be purchased for very low multiples. So you’re getting the value of that in the platform buy and build — without worrying about the viability of a smaller company trying to survive on its own without competitive advantages such as purchasing power or deep sales teams.”

Another reason this strategy is so attractive in the current environment is the availability of cheap debt which is allowing private equity firms to finance platform deals on a very favourable basis, leaving more cash for add-on acquisitions, according to Bernstein. “Lenders in the mid-market are falling over themselves to provide debt to sponsors,” he adds.

US demographic changes have also helped. “The normal generational transfer of family-owned businesses that we see is accelerating due to the general ageing of the population. Quite often, children don’t want to go into the family business, and that leads to opportunities for the older generation to partner with private equity managers as they seek liquidity,” Bernstein says. “We’re increasingly seeing entrepreneur and family-owned businesses look to partner with private equity firms or sell out completely. So there is an increasing number of target companies.”

APPETITE FOR DIVERSITY

As LPs direct more of their capital toward the mid-market — as with any increasingly attractive strategy — competition for the best managers has risen substantially. “Access is getting to be a very, very difficult consideration. Yet we are often able to secure slots with such top-tier firms because we’ve built numerous long-term relationships,” Duda says.
While Capital Dynamics puts the number of US mid-market firms at more than 500, there remains a supply-demand imbalance due to LPs’ preference for a handful of top performing managers.

“It’s definitely bifurcated,” Bernstein says. “The vast majority of firms must work extremely hard to raise money, but the top decile-type performing firms are fundraising very quickly, sometimes in as little as six months, and turning away investors.”

“We have particular respect for those managers who stick to their knitting by capping the size of their funds at or near the size of their prior funds, because they recognise that they are unlikely to produce the same types of returns if they buy larger companies. We tend to favour such firms, as do our peers, and that often results in the best performing managers becoming over-subscribed.”

One reason why having access to a wide variety of managers is especially important in the mid-market is the abundance of highly specialised strategies.

“You don’t want to take your entire mid-market allocation and just bet on any one sub-strategy, such as the technology sector or the turnaround sector or the buy and build sector,” says Duda. “We believe it’s very important to build a mid-market portfolio with diversified sub-strategies, and that may be best achieved with a fund of funds for a certain sized investor.”

For Capital Dynamics, maintaining a diverse portfolio of managers doesn’t just mean spreading dollars around according to sector specialisation.

“There are platform buy and build managers that may say they’ve got three or four industry specialties, but we’d still consider their primary expertise to be their ability to source and integrate numerous acquisitions,” Duda says. “We look at where they have invested over the past 10, 15 or 20 years and where they have earned their track record. For us, it’s more the expertise of their strategy and not necessarily any one industry categorisation.”

**GROWTH STORIES**

Nonetheless, the firm’s investment approach for the US mid-market is still predicated on which sectors have promising growth stories and which don’t.

“Technology has performed extremely well and continues to perform extremely well. Companies are improving their competitive edge through new software applications, cloud computing and the collection and analysis of large quantities of data,” Duda says. “The second [area] that we like which is a little bit controversial is consumer. We’ve found consumer managers that really do know how to find the right niche pockets of growth within the consumer industry.” The firm is also bullish on mid-market energy companies, ranging from clean energy to oil and gas.

However, three areas Capital Dynamics is under-weighting at the moment (despite the strong returns they’ve yielded in the past) are healthcare, financial services and media and communication.

In terms of size, Capital Dynamics prefers to invest in managers that operate above the lower mid-market, drawing the line at companies with an enterprise value of $50 million.

“Private equity firms that invest in sub-$50 million enterprise value companies (other than as add-ons) tend to be smaller shops, and we tend not to invest in funds less than $500 million in size,” says Bernstein.

But while picking attractive sectors and backing managers with strong track records in the mid-market will always be key to any fund of funds’ investment thesis, perhaps the most crucial detail for Capital Dynamics is how a firm grows businesses in its portfolio.

“We have always begun our due diligence on any mid-market manager – after getting to know them – by taking their historical track record and breaking it down into the key value drivers at the company level, so we know how much is from multiple expansion, or revenue growth, or margin improvement and how much is from financing.”

From Capital Dynamics’ vantage point, understanding how returns have been generated is the critical factor in determining the likelihood of their repeatability.
Capital Dynamics* is an independent, global asset manager, investing in private equity and clean energy infrastructure. We are client-focused, tailoring solutions to meet investor requirements. We manage investments through a broad range of products and opportunities including separate account solutions, investment funds and structured private equity products.

Our investment history dates back to 1988**. Our senior investment professionals average over 20 years of investing experience across the private equity spectrum. We believe our experience and culture of innovation give us superior insight and help us deliver returns for our clients. We invest locally while operating globally from our London, New York, Zug, Tokyo, Hong Kong, Silicon Valley, Sao Paulo, Munich, Birmingham (UK) and Brisbane offices.

**CAPITAL DYNAMICS US INVESTMENT MANAGEMENT TEAM**

Operating from New York and Menlo Park and supported by a global asset management platform, Capital Dynamics has a highly skilled and experienced team of US private equity investment managers; its senior investment professionals hold an average of over 20 years of experience. With a track record dating back to 1992, spanning various economic cycles, Capital Dynamics has a long-term track record of investing in a high percentage of US mid-market funds that are currently ranked in the top-quartile.

**FOCUS ON INNOVATION AND QUALITY**

Capital Dynamics is an industry leader in quantitative risk management; an essential component of successful private equity investing. The importance of risk management has intensified due to tightened financial regulations and heightened investor awareness.

Our portfolio and Risk Management team conducts customized, in-depth client portfolio analyses and our Portfolio Servicing team provides comprehensive and dedicated back office services for a diverse set of global investors.

We are proud of our distinguished reputation within the private equity community. In 2011 and 2010, we were voted “Fund of the Year in Europe” by Private Equity International. Capital Dynamics is a signatory of the United Nations Principles for Responsible Investment (PRI). Our emphasis on quality has been recognized with the International Standard ISO 9001:2000 certification of compliance.

**INVESTMENT TYPES**

Primary fund investments – We have invested in private equity funds since the late 1980s, spanning all geographies and strategies. We have established solid relationships with over 400 General Partners, and monitor over 800 active funds.

Secondary fund investments – Active in the secondary market since the early 1990s, we raised one of the first dedicated secondary funds. The combination of our large number of existing fund investments and proprietary databases often provides an information advantage when evaluating secondary transactions.

Direct investments – Our extensive relationships with the globe’s top-tier fund managers provide a consistent volume of high-quality investment opportunities. Our co-investment strategy is focused on mid-market buyouts, but also includes select development capital and special situations.

Clean Energy and Infrastructure – Our specialized team of senior industry investors employs a direct investment strategy focused on a diverse mix of clean and low carbon energy assets that can offer attractive risk-adjusted returns and compelling diversification benefits from this emerging class of real assets.

**STRUCTURES**

Funds of funds – Our private equity, primary and secondary funds of funds allow investors to implement a global allocation strategy through access to premier private equity managers, in addition to portfolio diversification.

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