The challenges of a changing mid-market

Mid-market private equity has been the cornerstone of the industry since it began, pioneering strategies and coming to define what private equity is. Mid-market managers have generated outsized returns for their Limited Partners (LPs) whilst helping portfolio companies become market leaders, but they are now facing a crossroads.

The mid-market's historical success has seen it becoming increasingly crowded, and managers in the space are having to evolve as competition for deals and LP attention continues to increase. Addressing their own competitiveness has seen some managers redefine who they are and how they operate, adapting to a rapidly changing environment. I want to explore here how they are evolving, and what this means for other mid-market managers.

What is mid-market

Broadly, mid-market private equity firms are those that invest in mid-market businesses. These companies form a significant part of the economy and represent a deep pool of attractive businesses for private equity managers. In the UK at the start of 2020, the 248,000 businesses with between 10 and 250 staff generated annual sales of more than £1.3 trillion: 33% of all private sector turnover. The German-speaking DACH region have long celebrated their "Mittelstand" which has served as the engine room of the DACH economies. They too have struggled to define the term, largely settling on an ethos of Mittelstand businesses than a statistical category.

The mid-market has consistently generated significant returns for LPs investing in the space. Mid-market buyouts in Europe generated an IRR of 17.01% since inception until the end of 2020, according to Invest Europe. The space outperformed listed equities by nearly 10%, and all buyouts by almost 2%.

These returns, along with the depth of opportunities in the mid-market, has seen the space become increasing popular over recent years. This year alone, in

Europe four brand name firms have launched dedicated mid-market platforms, closing funds of between €800m and €1.2bn. They join several other large-cap managers in establishing in-house divisions targeting the mid-market.

Alongside this, a new generation of emerging managers have entered the mid-market. These are often teams spinning out from larger firms, building on their experience to innovate around the traditional private equity model. With established track records and new approaches to operating a private equity firm, these managers are attracting a lot of attention from LPs.

The challenges of operating in an evolving mid-market

These factors combine to make the mid-market more crowded than ever, leaving managers facing existential questions about what the future of their business looks like.

Increased competition for high-quality mid-market portfolio companies has driven up entry multiples. Research from Clearwater International found an average EV/EBITDA multiple in European PE-backed deals of 11.8x in Q2 2021, the highest on record. Managers operating in this environment must look in detail at their deal sourcing to identify how they can access attractive targets sooner, bringing down entry multiples, and also at how they work to create value in their portfolio companies.

This competition extends to fundraising as well. LPs have an unprecedented number of options for backing mid-market private equity General Partners (GPs), and many face their own challenges around investing into private equity. Chief among these is managing a large number of relationships with GPs, and many are choosing to reduce this number and focus on a core set of managers. This gives an advantage to larger managers running a range of strategies and means dedicated mid-market firms must work hard to differentiate themselves from their competition.

Futureproofing mid-market private equity

Faced with these challenges, mid-market private equity firms are reflecting on their operating models and identifying how they can adapt to place themselves in the best position to withstand competition on the one hand and continue to create value for their LPs on the other.

Mid-market managers are increasingly narrowing their focus on the sectors and subsectors where their experience means they can add the most value. For example, a GP who may in the past have been a software investor might now focus only on business services software firms with an annual subscription billing model. This increasing focus on a narrow sweet spot gives managers an edge when assessing deals and working with businesses throughout the ownership period, as they will over time develop a deep understanding of how these businesses operate most effectively and can apply this across their portfolio companies. This narrow focus can also be a key selling point when GPs market themselves to LPs, who see dedicated expertise in core sectors as an important advantage in generating returns.

Related to this specialisation by sector and subsector is a push by managers to refine their value creation playbook and capitalise on strengths developed over time. An example of this is rapidly growing platform acquisitions through bolt-ons, where complementary product offerings or access to new markets can be built out quickly. Another area is in technological transformation at portfolio companies, for example implementing analytics to assess a company's client base. This can help management identify new subsets of potential clients, and also help maintain existing customers by flagging where engagement has dropped and a customer may be thinking of leaving.

GPs themselves are also employing technology to improve their investment strategy and make deal sourcing more proactive. Tools like big data, analytics and artificial intelligence are becoming the norm, enabling firms to identify potential acquisitions at an earlier stage and carry out smarter due diligence, faster.

Many are also adapting how they work with their portfolio companies. In some cases, this is through formalising groups of experienced entrepreneurs into in-house teams to work directly with management, providing hands-on support and advice. Other managers are doing this more loosely, forming networks of subject matter experts to support portfolio companies with things like improving product technology and developing and executing strategies to optimise sales.

Increasing competition in the space is forcing mid-market managers to change.

This may be through increasing sector specialisation, refining how they work with portfolio companies, adopting technology to improve operations or a combination of the three. This evolution is driven both by the need to not lose ground to competitors and to explore new opportunities to create value in portfolio companies and generate returns for LPs, and the firms who come to define what the mid-market in private equity is over the next decade will be those who embrace the need to change today.

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