KEYNOTE INTERVIEW

The rise of mid-market specialist funds

With so much competition for deals and investors, mid-market buyout funds are finding innovative ways to differentiate their offerings, say Baker McKenzie's Justin Hutchinson and Alex Lewis

Q How have the last 12 months challenged mid-market PE strategies?

Alex Lewis: The trend towards specialisation and the emergence of alternative strategies – both from existing funds and new entrants – was already well underway, but it looks set to accelerate. Over the last 12 months, an already competitive market has become even more so; strong competition tends to drive differentiation and specialisation, and private equity is no different, as managers look for ways to stand out from the crowd. At the same time, certain sectors have emerged as especially resilient and attractive to private equity.

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This combination of factors suggests a continued push towards specialisation in PE strategies.

Justin Hutchinson: Covid is accentuating the trend, as volatility can often exacerbate the need for specialisation. For example, in healthcare, socioeconomic trends have been driving significant deal volume for a while, but investors recognise that the foundational shifts arising from covid have not uniformly benefitted the industry. The industry breaks down into many sub-sectors with different dynamics, and having a fund focused solely on healthcare allows for the specialisation needed to drill down into the detail. Of course, generalist funds can achieve this too, but specialisation is something managers can sell back to investors to set them apart from other managers.

Q How are mid-market managers differentiating themselves? What specialist approaches are emerging?

AL: The most obvious type of specialisation is by sector; there have been funds focusing on healthcare and technology for some time now, but other more niche categories are emerging too. For these funds, the selling point to investors and founders is that because their investment teams only look at opportunities in that particular sector or sub-sector, they are better placed to maximise value creation and, crucially, to know when to pass on a deal. Often those funds will also have senior advisors who are industry veterans and have a deep understanding of what is going on from a policy and trends perspective.

Another type of specialisation is around the investment horizon, where we are seeing strategies emerging as alternatives to the typical three-to-five-year hold period. It is also now not always the case that these longer-term funds will expect lower returns: some of them are every bit as ambitious in terms of performance, but they offer the flexibility for investment strategy and exit timing to be dictated by what is right for a particular portfolio company, rather than structural pressures.

JH: Specialisation can be cultural as well. We have seen mid-market managers emphasising their pedigree, talking about their roots in consulting, or in venture and growth capital, etc, and what that means for their ability to execute particular types of transactions. A sponsor with a consulting and operational background may seek out targets in need of transformational change. A sponsor that is comfortable investing not for control can find value in strong founder-led businesses that control investors find difficult.

Q What industry- or geography-specific strategies are popular now?

JH: Regional players remain an important part of the sponsor landscape. They exemplify the benefits of specialisation and are in many ways a precursor to sector and strategy specialisation trends we are seeing now. Funds with a geographic focus can express familiarity with the trends that impact their particular market, know the language, know the local players and understand the nuances of the culture.

Geography-specific managers also benefit from building up close ties to advisors with strong local capabilities. In a hyper-competitive market, having strong ties to advisors with local expertise across multiple jurisdictions that can address local issues sensitively and efficiently can help drive deal success.

AL: Alongside healthcare, the other industry sector that is clearly booming is technology. Businesses and consumers are more enabled by technology and digitalisation than ever, so the opportunity for PE investing is huge. Because the space is evolving so rapidly, funds that have deep specialisation in the sector may be better placed to find opportunities early and navigate risk.

Q How might growing interest in longer-term holds shape the PE market?

JH: The long-term hold is interesting because part of the driver for all of this is the extremely competitive landscape for targets, which makes it tough to win deals, so managers need something unique. Offering that long-term hold is a distinguishing factor when they speak to management teams or founders, who are often attracted to the idea of patient capital and a fund that is happy to be in for nine or 10 years. Such a structure does create challenges around management incentivisation, because it can create tension with the fundamental approach normally taken by private equity, where managers and sponsors achieve liquidity at the same time, but that simply requires creativity from sponsors and advisors alike.

AL: A long-term-hold fund is a natural extension of one of private equity's key advantages over the public markets, which is that businesses do not need to be responsive to short-term performance targets and can instead take a longer view. There are also plenty of young founders out there who still want to drive their businesses over a number of years, so, in the right circumstances, a partnership with a longer-term fund can be an excellent fit.

Q If straightforward mid-market buyout funds no longer excite investors, what could the landscape look like a decade from now?

AL: The model of the generalist buyout fund is not dead. There are strengths that the big players have that will continue to make them a real force, both in winning deals and converting them into successful investments. The well-established generalist funds will carry on attracting some of the best talent and have huge pools of experience, resources and networks that can help them deliver for portfolio businesses, particularly where companies are looking to expand into new markets or adjacencies.

As Justin says, generalist funds do also develop deep specialisation in specific sectors and niches: I expect they will just come under increasing pressure to articulate that well to investors and management teams. That said, I cannot see the emergence of too many new multi-sector, broad-based buyout funds. New entrants will tend to be specialists in one way or another.

JH: It will be interesting to see the winners and losers among the new crop of specialist funds, and what winning looks like for those funds. Historically, you did well and then you raised more capital for your next fund to diversify across industries and geographies. Going forward, successful funds may not want to do that and may choose instead to grow in a different way, thinking creatively about the fringes of their core strategy rather than becoming everything to everyone. Further diversification looks inevitable in response to both investor and seller demand. ■

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