KEYNOTE INTERVIEW

A taste for US mid-market funds

LPs are looking for targeted strategies as the mid-market continues to outperform, says Jared Broadbent, head of fund services in North America at Alter Domus

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Q How have the events of the past 18 months impacted investor appetite for US mid-market private equity funds?

When the pandemic hit, there was a real question about how it would impact private equity and venture capital, given the nature of how those companies operate, and particularly how the mid-market would weather the storm. There was a rush to gain liquidity to support portfolios and a great deal of uncertainty, with the result serving as a litmus test for the resilience of the market. In fact, private equity did very well, both in terms of performance through the crisis and its ability to take advantage of the opportunities that arose.

Private equity appetite for mid-market companies has increased substantially over the last couple of quarters, with a definite trend towards investing in high-growth businesses, which are often to be found in the mid-market. The mid-market has always performed well, with typically more agile companies that can be a little less leveraged, and more room for the private equity manager to move the strategy around in real time. Investor appetite is robust and strong fundraising continues to fuel activity, so it will be interesting to see how these firms execute going into the longer term.

Q What are LPs focused on when looking at US mid-market managers? What are investor priorities?

LPs tend to be particularly focused on the specific industry expertise of the manager in the area that they plan to invest in. Generalist managers are not as appealing as managers that have set up with a focus and brought in industry veterans as operational all-stars, with a long track record of execution. That is where we have seen new and emerging mid-market managers raise significant amounts of money.

There are also some new asset class strategies that are increasingly appealing, such as private debt in addition to private equity, which we have seen capital flowing into. All of which comes back to the LP view that mid-market managers can outperform and generate alpha in today's environment.

It is much more difficult to find assets at bargain prices today. So, a group that is set up for success with a buy-and-build strategy, or that can find companies where it can come in and create real value without financial re-engineering, is where most see the path to success right now.

Alpha is going to be generated by true operators that can understand a portfolio company, provide value in terms of strategic growth and development levers, add to the knowledge base and provide networking opportunities with others in the industry.

Q What are the challenges and opportunities for mid-market managers around differentiation? How can managers stand out?

Specialists will stand out, as will platform-type portfolio companies and investing structures rather than just a variety of different investments in different places. Managers that are laser-focused on staying in their lane will be important, even in an environment where there is going to be a lot of pressure to deploy capital and search for deals. It is going to be critical for managers to demonstrate discipline, while the challenges will be around capital deployment.

Differentiation can come in many forms, whether it is from the operational perspective, the industry vertical or the geographies that a manager is able to access. But it is going to be difficult to continue to differentiate unless a firm has a specific team that has been constructed for a specific focus.

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A lot of this comes down to individuals. We have seen brand new private equity fund managers that come with a group of 30 or 40 industry veterans as operating partners and have no problem raising \$2 billion or \$3 billion for their first funds. It is about the team you have in place and how you plan to create value.

Q What issues are US mid-market managers focusing on with their fund administrators?

The real focus of our client base is around people, processes and technology, which is as it should be. In today's environment, for new managers, the question of what you do from an operational perspective and what you bring in-house is difficult. The labour market is incredibly hot in the US, making it challenging to acquire and retain talent, so it is tough for GPs to obtain and create the talent they need to run the back office.

That is driving a huge trend towards outsourcing, and it is increasingly incumbent upon us to offer career opportunities, with the right salaries and training. That is a growing focus for our clients, who want to hold us accountable for that.

When it comes to operational efficiency and scale, we are continuously pushed to automate what can be automated and bring in optical character recognition and artificial intelligence technology where it makes sense. We aim to streamline as much as possible and make sure our processes reduce the propensity for error. The pandemic has highlighted the value that having good data readily available to decision-makers can bring.

There is also a big focus on how fund administrators can support clients from a compliance and regulatory perspective, including around ESG. Managers are getting questions from LPs and turning to us for comprehensive solutions. Mid-market managers are often the ones with less experience or lacking the resources to address issues in-house, meaning they are more reliant on fund administrators.

Q What will be the hot topics for US mid-market managers going into 2022 and beyond?

ESG is going to take its rightful place as an important pillar of both fundraising and capital deployment. It is going to be given more focus and become more refined and developed.

There is a lot of dry powder in the mid-market, both from funds launched in the last two years and those raised in 2021. That wall of capital is driving increasing competition for good companies. Exits and investments will continue to be transacted at record multiples for good, high-growth companies.

The tax climate continues to evolve, including some recent developments around global tax solutions as world leaders agree in principle on the direction of travel. The US tax climate is fast-evolving and as some potential tax changes move towards becoming law, that will continue to drive dealflow. We have already seen record levels of exits in the last nine months based on the spectre of tax change and, as that becomes more of a reality, we will see even more. ■