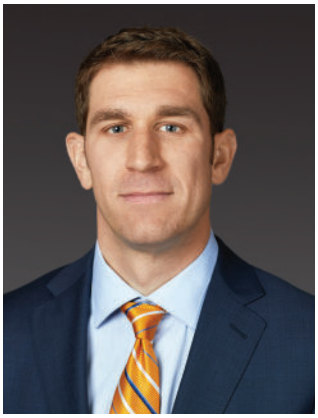
KEYNOTE INTERVIEW

Collaboration in the middle market




Scaled co-investment platforms receive most of their opportunities at the front end of a GP's investment process, say Churchill's Jason Strife and Anne Philpott

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Q What does the opportunity for middle market equity co-investing look like amid today's challenging environment?

Jason Strife: Market complexity can lead to very attractive opportunities for institutions that have co-investment capabilities. It's clear that, compared with a decade ago, there are far more eligible organisations that have both the expertise and the desire to be co-investment partners to private equity firms.

However, as distributions from primary programmes have decreased, we're beginning to see a lot of co-investment capital sitting on the sidelines. Many institutions are ill-equipped to transact, or have not built the required scale.

At the same time, you have a constrained lending market, and valuations for best-in-class companies are not necessarily correlating to what is available in the debt market. This dynamic increases the challenge and the need to pool equity capital in order to get deals done.

Churchill invests over $1 billion a year in leading middle market private equity funds, and nearly every GP in our portfolio has institutionalised their co-investment programme. These GPs need co-investment partners that can execute at scale, with the ability to move quickly and with certainty. Most co-investors are just not built to do that, so we have been able to seize those opportunities with GPs that see us as a dependable co-investment partner.

History shows that funds invested during or in the immediate aftermath of recessionary periods have been among the best performing vintages, so we are pleased to support our private equity partners through this period.

Q What are the major risks of co-investing?

Anne Philpott: Many LPs want to co-invest, but later find out it is harder to execute than they expected. It is also riskier when there are fewer deals in the market, coupled with this fear of adverse selection related to GPs only approaching LPs to co-invest in their leftover opportunities.

In our case, Churchill has built a very solid group of sponsors in our LP fund portfolio, with most being upper-quartile performers. We have well-developed relationships with those decision-makers, so even in a slower dealmaking environment, they show us essentially every opportunity, enabling us to be highly selective. Our unique model leads to over 90 percent of our co-invest dealflow being early-look or pre-syndication situations, so we can diligence and underwrite side by side with our GPs. They get our view and then syndicate the transaction out post-closing to others.

JS: Adverse selection can be a valid concern if you approach co-investment as if you are going to do a very high percentage of the deals you see, and can only access what GPs have left over in their portfolio to syndicate.

If you take the opposite approach, which is what we do at Churchill, you build your programme to receive as many opportunities as possible at the front end of GPs' investment processes. This way, you provide GPs with a solution to help them get deals done, you cast your net wide and, ultimately, you select very few opportunities. You give valuable, transparent feedback and just participate in the deals that are right for you. As such, that risk is removed.

Q What do you look for in a good co-investment?

JS: Some key elements of what we define as an attractive co-investment opportunity would start at the asset level. We very much have a flight to quality strategy focused on high-growth, non-cyclical, mission-critical businesses in the middle market. The focus is companies with an EBITDA sweet spot of between $10 million and $75 million.

We then hone in on the transaction dynamics. We build a deep understanding of what the GP does in terms of differentiation and value creation for their portfolio companies, and we make sure that opportunity exists in the deal we are looking at. We try to ensure the company's business model is consistent with the GP's resources, expertise and track record.

We are also very keen on leveraging our information advantage, so having over 200 private equity advisory board seats and sourcing most of our opportunities from relationships in our GP portfolio is important. We want to know the people seated at the table well so we can focus on relationship-based sourcing and gain an in-depth understanding of the co-investments we make. Also, we know which private equity firms perform best, and we make sure to align with them.

Q Why should investors continue to support the US middle market when large buyouts may show a lower dispersion of returns?

AP: The middle market is the powerhouse of the US economy and is a huge opportunity set, with over 300,000 businesses. The companies we target in particular are largely in technology, business services and healthcare – durable sectors with a lot of demand that are less subject to macroeconomic cycles. We believe there are consistent value creation opportunities to improve business models and professionalise operations for these companies, allowing sponsors multiple ways to drive substantially higher growth rates. As a result, we see our middle market portfolio companies and private equity GPs consistently outperforming and proving more resilient in times of volatility.

When we look at exit opportunities for mid-cap versus large-cap deals, there are just so many more options. You can go public, but in cases where the public markets are quiet, you can sell to a strategic, or another financial, sponsor. Or, as an owner, you can make further add-ons, or hold on and continue to work with other value creation levers. A lot of the companies we invest in are growing organically, creating value without those exit opportunities.

JS: The buying universe for middle-market companies is so much more mature and stable today. Twenty years ago, some of those companies might have tested the public waters as the primary exit route, but now there is a mature market of private equity buyers lining up to take advantage of the maturation of the middle-market ecosystem. A company can do extremely well under three or four vintages of PE ownership.

Q What future do you see for this strategy?

JS: In the medium to long term, I don't know how you couldn't be bullish about middle-market private equity assets generally. We have seen a consistent year-over-year pattern of private businesses increasingly and successfully undertaking institutional ownership, and we think that has a long way to run.

Co-investments specifically will continue to be a very useful tool for private equity firms to right-size equity checks, particularly in today's environment, as well as strengthen relationships with LPs.

The LP support for our own programme shows us many are viewing co-investment as a highly attractive, value-enhancing part of an overall portfolio strategy. We expect to see continued demand from investors, particularly given our unique sourcing model that leverages our private equity GP portfolio relationships. Ultimately, there are strong underlying fundamentals supporting growth in the space, so the future for this strategy looks really positive. ■

Jason Strife is head of Churchill's private equity and junior capital platform, and Anne Philpott is managing director of the private equity and junior capital team