"EMI IS A BATTLEGROUND OF EGOS. MY MONEY IS ON HANDS" P13

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LPs need alternatives to their risky mega-fund exposure. Charles Ind and Kevin Grassby of Bowmark hit the spot.

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SMALL IS BEAUTIFUL

The might of the mega-fund has dominated the fundraising landscape for the past few years. But as credit woes threaten big buyout returns, LPs are fighting for a piece of the small deal pie.

WORDS **AMY CARROLL** PHOTOGRAPHY **PETER SEARLE**

Nice little earners: Charles Ind (left) and Kevin Grassby of Bowmark saw their second lower mid-market fund hit its hard cap in just ten weeks

JUST TEN WEEKS AFTER LAUNCHING ITS second independent private equity fund last October, lower mid-market investor Bowmark Capital romped home to hit its £265m (€482m) hard cap.

Bowmark Capital Partners IV is more than double the size of its predecessor, which closed on £105m in 2004, simultaneously with the firm's spin out from Sagitta. Around 80 per cent of commitments to the new vehicle were received from existing limited partners, and the fund was heavily oversubscribed.

Part of the firm's fundraising success can be attributed to a string of successful exits over the past two years, including the sale of care home business Regard Partnership, TV production company RDF Media and bar and restaurant chain Living Ventures, all of which saw Bowmark more than triple its money. But the speed of the fundraising, and the level of demand it attracted, are also indicators of a wider shift within the industry.

The mega-market has been the holy grail of private equity for limited partners over the past few years, and this rapidly escalating supply of equity, coupled with an unprecedented supply of debt, means the biggest funds have been growing exponentially.

However, since these houses were paralysed by a sudden and almost complete withdrawal of credit last summer, LPs are starting to question their ability to deliver returns.

Where credit's due

"We have been through a period of history where mega-buyouts have outperformed every other part of the market, certainly in IRR terms," says Bowmark managing partner Charles Ind. "The amount of leverage available and an exit environment that enabled them to float businesses quickly, meant we have experienced a golden age for big deals.

"I believe we are entering a period where the mid-market is going to have its day and those big deals are going to suffer," he continues. "The supply/demand capital equation is not working in their favour any more. Everyone is talking about the overhang of debt, but what about the overhang of equity?"

"We are starting to see LPs shift away from the mega-market and look long and hard at the opportunities available in the smaller segment," adds Bowmark managing partner Kevin Grassby. "We certainly benefited from this trend."

Anecdotally, big buyout investors are coming under pressure from limited partners to scale back their fundraising ambitions. CVC Capital Partners is one investor that is believed to have quietly lowered its target.

However, others are resisting reason and are refusing to modify their fund sizes, despite the fact deal flow has been brought to a shuddering halt. These firms are relying on what Alexander Apponyi a partner at placement agent Berchwood Partners, refers to as their "one saving grace".

Increasing allocations

However disillusioned LPs become with mega-buyouts, their options are strictly limited.

According to a survey released by research firm Private Equity Intelligence this month, a number of pension funds and endowments are becoming more sceptical in their approach to mega-funds, and yet the same survey revealed that 52 per cent of investors are looking to maintain their overall private equity allocations, while 48 per cent are planning to increase their allocations.

It is almost impossible for investors to redirect their mega-buyout allocations to any other part of the market – partly because investing smaller sums in a larger number of funds is a costly and impractical solution, and partly because the capacity just isn't there. So where will all this money go? The numbers don't stack up.

For best-in-class small buyout investors, this means competition among LPs for access is immense. The challenge for Bowmark, with the help of placement agent Campbell Lutyens, therefore, was perfecting the art of managing a severely oversubscribed process.

"We recognised before we started that demand was going to exceed supply, so we excluded a large number of investors that had approached us from the outset," says Ind. "We didn't want to be in the situation where we were upsetting people by wasting their time, so we stuck to our existing investors and existing relationships – those that had been tracking us for three or four years."

Bowmark was also forced to scale back the commitments of the investors it did accept. Many of its existing limited partners' allocations

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CHARLES IND, BOWMARK

to private equity had climbed substantially in the four years since the firm closed its previous fund – much of it funnelled into the mega-buyout sphere – and their minimum commitments had grown accordingly.

“There was more demand from existing LPs than we could meet without creating an imbalance, so it had to be a very disciplined process,” says Ind. The firm could have raised substantially more – the fund is understood to have been oversubscribed to the tune of £400m to £500m – but Ind says it was important to restrict the fund’s size to maintain its strategy.

“We could have raised a lot more, but that would have been opportunistic,” he says. “We felt that £265m was the biggest we could go to while maintaining absolutely our current strategy – and it was that strategy that LPs were backing.

“Every private equity firm has these tensions. On the one hand you are ambitious – you have mouths to feed and you want to grow. On the other hand, you don’t want to go to bed every night with this pressure to put money to work, which will inevitably affect your returns. You need to find the right balance.”

Limited partners in Bowmark Capital Partners IV were happy to support the firm’s considerable step up in fund size, in part because it had already begun completing slightly larger deals.

“There was not as big a shift as the headline figures would suggest,” says Grassby. “We had already begun seeing deals that required a higher equity component and so had gone out and raised co-investment capital from our LPs.”

Bowmark’s four most recent transactions ranged from requiring £10m to £36m in equity.

Diminutive focus

Despite a slight shift upwards in deal size, however, the firm is adamant that its new fund remains positioned in the lower mid-market, targeting companies with enterprise values of up to £75m, primarily in business services, leisure, healthcare services, media and IT services.

Bowmark believes this segment is best positioned to benefit from the current shift in economic cycle – relying more on managerial enhancement and operational improvement than financial engineering – and has the most favourable competitive profile.

“You have the mega-market, which arguably used to be a good place to be. But now returns are set to fall,” says Ind. “Then you have the upper mid-market, which I think is highly competitive in terms of supply and demand for deals. The smaller mid-market is the least competitive segment of all.”

There are those that would argue that competition in the lower mid-market is as fierce as anywhere – a large number of new entrants have arrived in the past two years and the void they claim to fill is disappearing.

However, there is no doubt that competition in the upper mid-market is set to intensify, as a number of big names – including Advent International, Bridgepoint, PAI and Nordic Capital – gear up to raise €5bn to €6bn funds, cashing in on renewed appetite from LPs defecting from the mega-market.

LPs can shift their commitments from mega-funds to this new breed of mini mega-fund with relative ease. And the rumoured phenomenal success of these fundraising processes suggests they are happy to do so. Whether these general partners can maintain their historical returns, while doubling their fund size – and quite possibly while faced with competition from mega-houses looking for scraps – remains to be seen.

The truth is that there are few parts of the European buyout market that are not choked up with capital. With mega-deals off the cards for now, and few institutions prepared to take money out of the asset class, something will have to give.

Short of a miraculous turnaround in the credit markets, private equity’s vintage 2008 is fast reaching its structural limits. ●

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