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Investors turn to smaller buy-out funds as mega groups face agony

By Martin Arnold

Small is beautiful again for private equity investors as they conclude that the mega buy-out funds that dominate the industry face prolonged agony, and switch to specialists in small buy-outs.

Investors and their advisers told the Financial Times that the tide had turned against the big buy-out groups, which rode the credit boom to become known as "the masters of the universe".

The mega buy-out funds – such as Blackstone, Kohlberg Kravis Roberts, TPG, Permira, and Bain Capital – are blamed by investors for over-leveraging deals to buy blue-chip companies, many of which are expected to be hard hit by the financial and economic crisis.

Now, many cash-strapped investors are either stopping new investments in private equity, or looking for smaller, local buy-out funds that specialise in acquiring little-known companies and helping them grow.

"Investors are wondering if, at the big end, the model still has validity," said Charlotte Thorne, founding partner of Capital Generation Partners, which advises investors on $2bn (£1.4bn) of assets, including private equity.

"Without the privileged financing they once enjoyed, do the mega funds still have an edge over the smaller firms?"

Because the mega buy-out groups raised $10bn-plus funds and floated on stock markets, investors say their alignment of interests is weaker. Instead of making their fortunes solely from carried interest – the share of profits paid at the end of a fund after money is first returned to investors – buy-out bosses have become rich from floating their firms and levying regular fees on massive funds.

But in the past 18 months the big deals have all but vanished.

In the fourth quarter of last year, the average buy-out size was $78.8m, down from $280.8m in the final quarter of 2007 and $726.3m in the last three months of 2006, according to Dealogic.

Investors are preferring smaller buy-out funds, such as Riverside Company, which has offices across the US, Europe and Asia targeting buy-outs of less than $150m – because they are seen as having more chance of doing new deals. "The advantage of small and medium-sized firms is the greater flexibility of their companies, most of which were bought with less leverage and at lower prices," said Hanspeter Bader, head of private equity at Unigestion, a Geneva-based investor with $9.5bn under management.

Mid-market funds finding favour

GENERAL FINANCIAL

News analysis

The appeal of mega-funds is being called into question, writes Martin Arnold

Asked why he prefers investing in mid-market buy-out funds over the "mega buy-out" end of the market, David de Weese, partner at Paul Capital, replies: "It is easier to turn a sailboat than a supertanker."

"I don't buy the argument that big companies do better in a downturn," says Mr de Weese, who invests in second-hand private equity interests for Paul Capital, one of the world's biggest "secondary" investors.

The charge sheet against mega-funds is long. They are criticised for using too much debt, overpaying for large companies and raising excessive funds that generate such big fees their interests are no longer aligned with investors.

Lorenzo Lorenzotti, managing director of ACG, a Paris-based fund of funds, says: "We believe the alignment of interest is not there any more for the big funds. We like the mid-market guys who roll their sleeves up and get their hands dirty."

The attractions of the mid-market include its lower debt levels and the cheaper prices paid for deals, even in the credit boom. Marleen Groen, founder of Greenpark Capital, a €1.3bn ($1.6bn) mid-market secondary investor, says: "When we buy mid-market funds in the secondary market, their deals are at that point in time often leveraged around only three times, which is much more attractive than secondaries in mega-funds."

Others admire the flexibility of mid-market houses and their ability to sniff out deals of which others are not aware. Charlotte Thorne of Capital Generation Partners, an investment adviser, says: "It is easier for smaller firms to find opaque deals that they can still value better than us, but are there those deals at a bigger level?"

Charles Ind, managing partner of Bowmark Capital, which raised £270m ($393m) for mid-market deals last year, says: "Some mega-funds will be forced to put their hands up and admit, 'okay we can't invest all this money', so there will be smaller funds, smaller fees and smaller deals."

There are signs that some larger buy-out houses are shifting to smaller deals. Candover said last week it would revise its strategy to seek smaller deals after unveiling plans to return much of the €3bn fund it raised last year to investors.

Nigel McConnell, managing partner of Cognetas in the UK, says private equity is going back to how it was in the early 1990s. "It is about grubbing around for mucky deals with companies that no one has ever heard of," he says.

Some mid-market houses say they are well-positioned for the credit crunch. Bill Crossan, managing director of Close Growth Capital, says that his firm has the "perfect product" as it provides both debt and equity for small-cap buy-outs.

While many mega-funds are shrinking, Karsten Langer, partner at Riverside Company, a US mid-market firm targeting sub-$150m buy-outs across the world, is considering opening a London office and is adding to its 190 staff. "We feel good about doing deals as we are not constrained by problems in our portfolio," he says.

In the US, the total value of mid-market deals worth less than $1bn halved from $65.5bn in 2007 to $32.7bn last year, according to research by Baird, the investment bank. But this was more stable than $1bn-plus deals, which fell 92 per cent, from $408.8bn in 2007 to $32.5bn last year.

Yet it is not plain sailing for mid-market firms. Mark Wignall, chief executive of Matrix Private Equity Partners, says: "There is a mismatch between buyers and sellers and we don't think the UK mid-market will recover before at least the autumn."

Another problem is that banks are playing hardball with smaller companies. "Some of the banks are being incredibly aggressive," says Ross Marshall, chief executive of Dunedin. If a small company loses its working capital facility, it can collapse fast.

Neil MacDougall, managing partner of Silverfleet Capital, says banks are overwhelmed: "The fires the banks are fighting have multiplied. Some banks have almost their entire leveraged loan book in covenant default or on default watch."

The bigger buy-out houses argue they have the smartest people, the strongest relationships with lenders and have historically outperformed the mid-market. They say this will not change in the long term. Greg White of THL Partners in the US says: "The mega-funds got where they are because they were the most successful."

Gordon Hargraves, partner at RHO Fund Investors, a $2.1bn private equity fund, says mega-funds will always be needed by the biggest investors. "If you are a big investor trying to put $2bn to work quickly, then you are attracted to the mega-funds," he says.

Yet even Henry Kravis, co-founder of KKR, admitted this month: "We have to accept . . . that deals will be smaller. The financing for large transactions simply is not available in the current environment. That's a fact."