

# Co-investments in the lower mid-market: from inefficiency to value

Co-investments in the lower mid-market segment of the private equity sector can offer distinct advantages, says Cameron Payne of Federated Hermes Private Equity. In conversation with Financial Investigator, he discusses deal flow, time to liquidity, and how pricing inefficiencies translate into opportunity.

*By our editorial team*

## **What makes the lower mid-market segment particularly attractive for co-investments at this moment?**

‘Against a backdrop of sluggish M&A volumes, macroeconomic uncertainty, higher cost of (debt) capital, and difficulties exiting portfolio companies, we see that the lower mid-market has many relative attractions. This is a deep market consisting of thousands of businesses, often with enterprise values of less than \$ 250 million, which allows us to build a broad deal flow funnel, to be strategy-led in terms of our focus (with regards to sub sectors, business models, value creation approaches) and to deploy capital consistently.

In many of these smaller company settings, value creation is inherently operational, focused on professionalising businesses and institutionalising processes, which can mean returns are less correlated to broader macroeconomic conditions and require less financial leverage to generate attractive returns. Lastly, as it relates to exits, the universe of buyers at exit for a <€ 1 billion enterprise value business is broad, whether it be other PE funds or strategic acquirors, which means that dependency on the IPO market is low. We therefore expect to see a shorter ‘time to liquidity’ and more consistent Distributions to Paid-In capital

(DPI) generation within our lower mid-market investment cohort. We think that this will continue. We are observing that a disproportionate amount of fundraising activity and dry powder formation is occurring in the upper-mid-market and large-cap space, who are natural buyers for these sorts of businesses at exit.’

## **Which types of businesses in the lower mid-market tend to offer the most compelling risk-return profile for co-investors?**

‘Common weaknesses that we identify within lower mid-market co-investment opportunities are key person dependency and limited management team bandwidth (which requires investment into the business to solve), customer, channel and/or supplier dependencies, and the existence of larger well-funded competitors.

While the first weakness is often inherent in this style of investing and can be solved through partnering with truly operationally minded lead GPs and through diversification, we find that the opportunities which have strong mitigants to the second and third weaknesses offer the most attractive risk-return. Sector-wise, this can often be found in software, IT, business services and certain healthcare verticals, specifically in well-defined niches where a lower mid-market business has a strong right to win. We get particularly excited when this is accompanied by a clear and decisive theme that is driving demand in a given market and a low amount of financial leverage. The latter we think is especially important within this market segment.’

## **What are the key factors driving pricing inefficiency in this segment, and how does pricing inefficiency translate into opportunity?**

‘Attractive pricing in the lower mid-market is often driven by seller dynamics and competition. Many transactions that occur are ‘primary’ in nature, meaning that the incoming PE firm is often the first institutional owner of the business beyond family or management, who typically will retain a meaningful stake. In such cases, sellers are often not maximising for price, but are also solving for considerations such as protecting the legacy of a business and making sure that the new owner shares common values and vision. Trigger events for such transactions, such as founder

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succession and estate and tax planning, can often also necessitate the speed of execution at the expense of price. While intermediation is generally becoming more common and sophisticated across M&A markets, the high volume of lower mid-market businesses across Europe (compared to the number of funds pursuing them) means that it is not uncommon to see bilateral negotiations occurring in the lower mid-market, particularly in markets such as Spain, Italy, Germany and Central and Eastern Europe. While ‘buying well’ is often not in itself a recipe for PE success, doing so in combination with the successful execution of a transformational value creation strategy, which improves the business and makes it attractive to larger PE firms or strategic acquirors, can unlock outsized returns.’

#### **How do due diligence requirements and process timelines differ for co-investment in the lower mid market?**

‘While no two co-investment processes are the same, we have observed that co-investing in the lower mid-market generally requires a hands-on and intensive approach. This is driven by the fact that the underlying transaction processes can often be unstructured in nature, that the businesses in question are often not as data-rich as would be ideal, and that the GP managing the investment does not have repeated experience of running co-investments or a large investor relations function to manage this. As a result, co-investment teams in the lower mid-market need to be comfortable working on a focused list of diligence items, working collaboratively with the GP to get the data and referencing necessary to support their decision, and need to be prepared for processes that can become quite drawn out and stop-start in nature.

Lastly, we believe it is critical to spend time with and assess management teams where possible, even as a co-investor, given that in lower mid-market situations they are often central to the investment outcome.’

#### **What role are emerging managers and independent sponsors playing in this segment? What are the considerations when partnering with these players?**

‘Private equity is a dynamic industry that can be characterised by the continual formation of new funds. The growth and institutionalisation of certain GPs, a failure to plan for succession, a slowdown in fundraising momentum and lower expected carry payouts are just a few factors that continue to drive a steady flow of emerging manager and independent sponsor propositions in the market. Many of these players are active in the lower mid-market specifically, often being driven by a desire to ‘return to their roots’ of hands-on investing alongside founders and management teams, or seeing an opportunity to bring an innovative approach to the market.

As these groups look to become more established in the market and build LP relationships, they can be prolific generators of co-investment opportunities. They can be attractive investment partners, given that their limited portfolio size can lead to a high degree of focus and support for each investment, and that they are clearly aligned in terms of generating strong investment returns. Given that these are younger organisations, the depth and breadth of the team and firm infrastructure are often key considerations when choosing a co-investment partner. Being able to reference extensively among close associates is an important part of the diligence process on the manager – alongside the co-investment – in order to build a clear picture of character and capabilities.’ ■

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## **SUMMARY**

The lower mid-market is attractive for co-investments due to deep deal flow, operational value creation, broad exit options, and less reliance on leverage or IPOs.

The best opportunities are in niches like software, IT, business services, and healthcare, where risks such as customer or competitor dependency are mitigated.

Pricing inefficiencies arise from founder-led sales, legacy considerations, and bilateral deals, creating opportunities when paired with strong value creation strategies.

Co-investing requires intensive due diligence, close GP collaboration, and strong focus on management teams, with emerging managers and independent sponsors offering both opportunities and added considerations.