KEYNOTE INTERVIEW

Tactical opportunities in the mid-market

A lack of liquidity is creating new opportunities to partner with mid-market managers and their portfolio companies, says head of Northleaf Capital Partners' private equity programme, Michael Flood

Q How would you describe the current macroeconomic environment, and what opportunities and challenges is that creating for LPs?

Sentiment around the economy is certainly becoming more positive as we look ahead to 2025. Inflation continues to moderate, we have seen further interest rate cuts, and generally speaking we are trending towards a better path.

However, several concerns remain from a macro perspective. The first involves the geopolitical environment. There is also continued uncertainty from a monetary policy point of view, as well as public markets volatility to contend with. These challenges are impeding the full recovery of a private equity industry that has experienced a significant slowdown since mid-2022.

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Deal volumes have started to rebound, but they remain well below the levels seen in 2021 and 2022. More specifically, private equity is continuing to suffer from a lack of exits. The median hold period has extended considerably and, as we all know, industry NAV is sitting at an all-time high, exceeding $3 trillion. All of this is putting pressure on fundraising, as LPs wait for the distributions they need in order to make fresh commitments to new vintages.

However, looking on the bright side, I do think that the worst of the slowdown is now behind us. In addition, we are seeing some really attractive pockets of tactical opportunity within the mid-market.

Q Against this backdrop, why do you believe that the mid-market is the place for LPs to be?

For the past two decades, we have built our business on the premise of providing LPs with the benefits of mid-market investing: less competition for deals, relatively attractive valuations, and more inefficiency creating greater opportunity to generate outsized returns among them.

There has always been higher potential for growth and more opportunities to make operational improvements in the mid-market, given lower levels of professionalisation. There is also greater flexibility and adaptability, as these mid-market companies tend to be more nimble. And, of course, there is a broader range of exit options available.

These longstanding benefits have never been truer than they are today, at a time when high valuations and heightened competition define the large-cap buyout space. But we are observing a new wave of opportunities in terms of the ability to partner with mid-market GPs and their companies. Private equity firms that focus on the mid-market tend to be more receptive to this type of relationship-orientated capital, making an integrated platform approach the best way to find success there.

Our strategy is to provide solutions to mid-market GPs across the entire spectrum of investments, from primary investment in funds to co-investment, capital solutions (such as preferred equity and NAV lending), credit and secondaries. By staying in constant dialogue with GPs with which we have built relationships over many years, we are able to create solutions that address their challenges and opportunities, and enable them to build value.

Q As a multi-strategy manager, where are you seeing the greatest relative value?

One of the biggest challenges that private markets participants are facing at the moment is a lack of exits. That has hindered the flywheel, preventing the flow of capital back to investors. However, as we have seen in past cycles, whenever there is illiquidity, there is also opportunity.

Right now, there is a significant opportunity stemming from GPs and LPs that need to generate liquidity and therefore need to find a route to exit, and also from those that want to raise capital to finance the next stage of growth in their best companies.

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These may be companies that they had not planned to own at this point in the investment lifecycle, but which they nevertheless wish to hold onto in order to achieve the best possible value at exit.

Many LPs that need liquidity are using the secondaries market to achieve that goal. Indeed, there is a pronounced imbalance between demand for liquidity and available supply of capital. This is creating a favourable dynamic, and we expect to see the largest volume of secondaries transactions ever in 2024.

In addition to LP-led secondaries activity, we are also seeing more GP-led secondaries opportunities coming to market as fund managers look to put their best companies into continuation vehicles. This enables them to hold onto their best assets while also offering liquidity to their investors.

When it comes to managers and investors looking for growth capital to inject into their companies, we are seeing attractive opportunities for different strategies across our integrated platform. It could be that a manager is looking for private credit to refinance a company. It could be that GPs would

Q Despite the advantages that the mid-market offers, there has also been a pronounced shift towards LPs consolidating their GP relationships and investing more capital in the biggest funds. How can these two trends be reconciled?

It is certainly true that LPs have been favouring large, well-established managers over the past few years, and that trend has only accelerated. Indeed, the 10 largest private equity buyout funds have accounted for nearly 40 percent of all buyout capital raised to date in 2024, according to data from *Private Equity International*.

This consolidation has primarily been driven by LPs' desire for simplicity, and for risk management and operational efficiency. They are putting more dollars behind a smaller number of managers, but this does not negate the inherent advantages that mid-market investing offers and there are certainly ways to reconcile these two trends.

Many LPs have begun to adopt a balanced portfolio approach where they can combine those core relationships with large managers that are raising the biggest funds, while also deploying a strategic portion of their allocation with mid-market managers and funds. We have seen this play out across private equity, credit and infrastructure.

We call it the 'core satellite model'. This allows LPs to enjoy the benefits of scale, while also gaining exposure to the value creation, diversification and enhanced returns that the mid-market offers.

Finally, I would add that the trend towards consolidation of managers is also taking place in the mid-market itself, especially with players who have an integrated multi-strategy platform. In fact, more than 50 percent of our investor base is investing across multiple asset classes within our platform, precisely because they recognise the dual benefit of consolidating their manager relationships and leaning into exposure in the mid-market.

like follow-on capital for an existing business.

Alternatively, if the GP wants to avoid diluting its equity position, they may seek out a specialist capital solution such as preferred equity. We have seen an increase in these types of tactical opportunities over the past 18 months and we expect that to continue into 2025.

Q What sorts of questions should LPs be asking of multi-strategy managers in terms of what it takes to successfully run an integrated platform?

LPs need to ask all the same questions that they would ask a single-product firm in terms of investment strategy, capability and track record. But I would suggest they also delve into the organisational structure of the platform to really understand how integrated the teams are.

For example, an investor might ask how teams are organised across the different product lines, how they collaborate, and what mechanisms are in place to ensure alignment and coordination. It is important to explore how the firm shares information, insights and expertise across the platform, and the technology that it employs to support the sharing of information.

There is a real power to the platform approach in terms of identifying and prioritising dealflow, but only if the right foundations are in place.

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Q How do you see the private markets industry evolving? Will we continue to see consolidation among managers, and will there still be a place for specialist firms?

This is a fascinating industry to work in. It has grown and adapted in myriad ways across the cycles and I am constantly amazed by the industry's ability to innovate and adapt. One of its key evolutions has been the rise of multi-product mega-firms. The extent to which capital has made its way to those firms over the course of this year has been particularly striking.

Specialist firms certainly have a role to play in offering investors targeted, complementary and tactical exposure. Sector-specific funds and those focused on the mid-market sit firmly in that category, and these will continue to comprise a core element of a diversified private equity portfolio.

When it comes to the mid-market in particular, the best firms are borrowing a page from the large- and mega-cap playbook, and developing integrated multi-strategy platforms to tackle this specialised segment of the market. ■