Democratising Small and Mid-Cap Global Private Equity

Stockholm (HedgeNordic) – Schroder GAIA II – Specialist Private Equity is a highly differentiated strategy, offering access to small and mid-cap deals, in selected growth oriented industrial sectors, managed by restricted access smaller private equity managers globally, with Asian exposure to China and India. The semi-liquid, open-ended, evergreen vehicle structure is also distinctive in offering potential liquidity while avoiding capital calls and distributions, and requiring a minimum investment of only USD 50,000.

Profitable Companies and Competitive Valuations

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Schroder Adveq, part of Schroders Capital – which is the umbrella for all private assets products and solutions within the global asset manager Schroders – invests along the whole lifecycle of businesses including venture capital strategies investing pre-profit with longer time horizons to mature profitable companies. Schroder GAIA II – Specialist Private Equity fund invests predominantly in profitable companies, which are often bought from families and founders. While most asset class valuations – including large cap private equity – have expanded in recent years, especially small-cap private equity deal multiples have been remarkably stable for over a decade, fluctuating around 8 times EV/EBITDA. Less capital is chasing these opportunities and leverage parameters place a ceiling on valuations: “Larger funds were able to raise billions from larger investors but smaller PE funds in Europe are pretty consistently raising overall around EUR 10-12 billion per year in total. Small funds soon become mid and then large funds so turnover is high. Leverage and acquisition finance multiples in small cap are 3-4x EBITDA so managers who want to maintain a 50/50 debt to equity ratio cannot pay more than 8x EBITDA. At the larger end leverage is reaching higher levels often in the range of 8-10x allowing managers to pay 14-16x,” explains Benjamin Alt *(pictured)*, Head of Global Private Equity Portfolios at Schroders Capital.

Accessing Smaller Private Equity Managers and Companies Globally

Smaller firms are generally accessed through smaller managers: “we were one of the early backers of several larger buyout firms like Sweden’s EQT, which is a fantastic firm, but is now well above our core target size. Investors do not need us to access the largest 25 private equity funds in Europe. We cover 800 smaller funds in Europe, 1,500 in the US, and more than 5,000 in India and China. One of our smallest ever private equity manager was Sweden’s Ceder Capital, which raised EUR 35 million for their first fund. Today our smaller funds are ranging closer to EUR 100 or EUR 200 million, and we define “small” up to EUR 500 million and mid up to EUR 2 billion. In terms of company enterprise values, small is an up to EUR 100 million and mid is between EUR 100 and EUR 500 million,” says Alt.

China and India

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He is especially excited about growth in Asia: “We have been active in Asia for over 15 years, first in China and then India. We are also looking at South East Asia and do not include more developed markets such as Japan and Australia in our Asia bucket. We were one of the first foreign private equity managers to build a joint venture in China that allows us to also access RMB funds. In five years, China could easily be the largest private equity market in the world, given its economic growth rates and fast developing private equity market. In 2020 it was a great diversifier, roaring back in March, April and May when Europe was at a standstill. India has huge potential as it is several years behind China in terms of private equity market development".

Growth and Recovery Sectors

Globally we focus on five verticals: healthcare, technology, consumer, business services and industrials, and are active from venture / growth to mature buyouts.

"In Asia we do not invest in suppliers to Western corporates we rather focus on local demand that is driven by a fast growing middle class. Globally we focus on five verticals: healthcare, technology, consumer, business services and industrials, and are active from venture / growth to mature buyouts. We allocate to very specialized managers who help companies to grow through active transformation like consolidation, international rollouts and professionalization. After a period of focusing mainly on less cyclical business given where we were in the cycle some more cyclical business can be interesting targets over the coming months. Companies in sectors that really suffered during Covid pandemic can now come out much stronger.

Semi-Liquid Structure

The private equity business within Schroders Capital (formerly known as Schroder Adveq) is for the first time offering an evergreen structure, with no distributions and capital calls (though the underlying investment funds which will make up the minority alongside the direct / co-investments nearly all have a traditional structure of capital calls and distributions). "This has been enabled by the Schroders acquisition, which provides the necessary expertise and strong overall platform. We also need a strong pipeline of dealflow: globally we always have 50-70 deals in the due diligence stage, so that we can swiftly deploy inflows," says Alt.

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The normal life cycle for a private equity funds is about ten to twelve years allowing for buying, developing and selling companies within an average holding period of approximately five years, but the fund offers potential for calendar quarterly redemptions up to 5% of the net asset value, dealing with the fund itself and at NAV. Redemptions are not guaranteed, but there are several features that reduce the risk of the fund being unable to meet either capital calls or redemptions or both, even under a 2008 scenario stress test. "It typically holds cash of 10-20%, which could cover two to four calendar quarters of redemptions. On top there is a credit facility of around 20% of NAV provided by Schroders, which is available to fund underlying capital calls through a period of low distributions. The fund can suspend redemptions for four consecutive quarters. If there are still redemption pressures, the secondary market, which has grown enormously over the past decade, could also be used to create liquidity," says Alt. "We saw very few redemptions in 2020 and have been raising 15-30 million per month recently".

Primaries, Secondaries, Co-Investments and Fees


Johan Strömberg, Director, Private Asset Sales – Schroders

"The semi-liquid structure does not compromise our strategy, which is a fully fledged PE fund, including private equity funds, secondaries and direct / co-investments," says Johan Strömberg, Director Private Assets. "The cash weighting of 10-20% does imply some cash drag which we estimate at about 1% per year, but in traditional private equity structures, fees are charged on committed capital in the first years of deploying the fund. Our investors get exposure to a globally diversified portfolio that has a paid-in level of around 75% from day one," says Alt.

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Fees for smaller PE managers tend to be sticky around 2% management fee and 20% carry above a hurdle of 8%. "It is hard to go below 2% at the smaller end, and managers will not get rich on management fees," says Alt. Direct / co-investments are nearly all alongside existing managers and pay no fees in about 90% of cases historically (some GP led transactions might have fees, those are typically below 1% and carry only applies above hard hurdles based on capital multiples of 2-3x net to investors).

Performance

But net returns are what count and Schroder Adveq's IRRs have ranged between 15% and 31% every year since 2010, with 2020 being one of the best year in the firm's history in terms of total investment result. Benchmarking performance is not a straightforward exercise, given the mix of primaries, secondaries and co-investments, the diversified geographic split, differences between vintages, and some funds not publishing performance data. "Nonetheless, our analysis of Preqin data shows that with our multi strategy funds we consistently rank within the top five providers that launched more than five funds since 2006. Based on our analyses more than 80% of our funds are first or second quartile compared to their peers," says Alt.

Examples of Co-Investments

The business has had a spectacular success with Chinese fashion designer and toy company, POP MART, which has been strongly growing its revenues over the last couple of years and has accomplished a very successful IPO in December 2020. Other winning investments have included firms bought from founders, such as German digital transformation agency,]Init[, which was founded in 1995 and serves SMEs and Governments. "It has benefitted tremendously from Covid accelerating the digitization trend and helping both SMEs and authorities to digitalize their processes," says Alt. Healthcare has also generated impressive growth: UK generic pharmaceuticals firm Essential Pharma, which was founded in the 1980s, has grown far above market growth thanks to a niche strategy of focusing on low volume, clinically important drugs.

ESG

Sustainability goes hand in hand with the big megatrends of demographics, digitalization and environmental topics.

"We were one of the first private equity firms to sign up to the UNPRI, in 2010, and has a structured ESG process with senior people on our ESG committee. ESG plays a role for every investment. Sustainability goes hand in hand with the big megatrends of demographics, digitalization and environmental topics. As well as avoiding corruption, environmental risk, and ensuring workforce quality and safety, we are proactively helping to improve companies," says Alt. "We are one of the first investors in Summa Equity in Sweden, which clearly is a leader in sustainable private equity, only investing in firms with a sustainability angle or trend," says Private Assets Director, Johan Stromberg.

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"Our biggest project is moving ESG from a qualitative to a more quantitatively driven approach, with realistic, measurable, digestible and relevant key performance indicators. We hope for some standardization in the industry over the next years. The goals must be that the majority of underlying companies are able to report on KPIs that help to improve the businesses in terms of better ESG," says Alt.

Stromberg sums up: "Sweden is a highly sophisticated PE market with one of the world's best GPs in EQT. We need to bring something different to the market. We are offering well diversified access to the more complex end of the PE market, with liquidity in between pure play private equity and a hedge fund. This is complementary for institutions and intermediaries."

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