The middle-market: Europe’s real economy strongman
THE MIDDLE-MARKET

During the depths of the financial downturn, in 2007-2010, mid-market companies in Europe’s four largest economies created 200,000 jobs. When we emerged out of that difficult time, 96% of those firms had survived.

The closer I look at the statistics, the more convinced I become that one of the answers to Europe’s economic recovery lies in this strong but often neglected segment of the real economy. According to the latest figures, mid-market businesses make up 1.5% of companies in Europe’s four largest economies yet account for 32% of their private sector workforce. Not only that, in 2010 they contributed €1.1trn to the GDP of those nations. If the middle-market sector of these economies were a country, it would be one of the top 10 economies in the world.

We need to do more to support these engines of growth. State aid and regulatory protection for SMEs tend to be targeted according to definitions of size based on turnover and employee numbers.

Mid-market companies regularly punch above their weight, reporting turnover figures that raise them from the official SME bracket, although they don’t have the infrastructure and resources to bear regulatory burdens in the way that large companies can.

Private equity fund managers often specialise in running mid-market businesses. Experience tells us such companies are more accurately defined by a shared set of characteristics than metrics based on employee numbers and turnover. They have owners with a strong sense of personal responsibility; they are export orientated with a global reach; they focus on innovation and the long term; and they use modern management techniques.

What they sometimes lack are the operational expertise and access to capital to move to the next phase of growth. Private equity, with its philosophy of active engagement, can meet both of these needs. Indeed, the middle-market is where we often have the greatest impact because these companies are receptive to change and flexible enough to respond to it quickly.

To realise its full potential, more support and recognition from governments and regulators at national and European level is in order. Given better access to capital, more financial incentives and a friendlier regulatory structure, Europe’s strong middle-market could power the real economy back to growth.

Dörte Höppner, Secretary-General

INSUMMARY

- Middle-market companies regularly punch above their weight in terms of sustained job creation and revenue generation
- Middle-market companies are more accurately defined by their shared characteristics than their size
- Middle-market companies have remained resilient against the downturn, creating a micro boom amid the macro gloom
- Private equity’s philosophy of active engagement is a good fit for middle-market companies, which need operational expertise, capital and patient ownership to grow
Europe’s middle-market companies regularly punch above their weight. They have an important role to play in the region’s economic recovery but they need backing to prosper.

Not big and not too small, mid-market companies are increasingly seen by business leaders in Europe as the engine to power the region back to growth. This often-overlooked slice of the market employs more people than small firms do in the region’s four largest economies and packs a significant GDP punch.

Mid-market companies are increasingly seen by business leaders in Europe as the engine to power the region back to growth.

An ESSEC Business School report called *The Mighty Middle: Why Europe’s Future Rests on its Middle Market Companies*, published in June 2012, assessed the significance of the mid-market in Germany, France, Italy and the UK. The analysis found that the mid-market in these four economies comprises just 1.5% of companies but supports 32 million jobs and generates €7.4trn of revenue. On average, this section of the real economy contributes more to GDP for its respective countries than large or small firms. These highly productive mid-market companies also proved to be more resilient than larger firms during the recent downturn.

While this group is among Europe’s strongest prospects for growth, funding pressures and lack of access to capital threaten to frustrate its ambitions and drag the region’s broader economy down too. ‘Either Europe’s mid-market will prosper or we will face much more severe issues than we face today,’ warns Rantum Capital, a specialist fund manager providing equity to Germany’s Mittelstand.

Defining the mid-market

What constitutes a mid-market company varies across Europe. *The Mighty Middle* report found that Germany’s Mittelstand includes companies with annual turnover of between €20m and €1bn, while comparable businesses in France generate between €10m and €500m. The way mid-market firms are managed is a unifying factor, though, and is considered crucial to their success. High levels of personal responsibility characterise the sector, be it through private or family ownership, or private equity backing.

Mid-market companies are also united by the challenges they face. They often need operational expertise to move forward.

BY THE NUMBERS

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<th>Percentage</th>
<th>The percentage of total companies in Germany, France, Italy and the UK comprising mid-market firms</th>
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<th>Trillion</th>
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<th>Million</th>
<th>The number of private sector jobs created by mid-market companies across Germany, France, Italy and the UK</th>
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Source: ESSEC Business School
to the next phase of growth, while succession and talent issues are other pressures. But topping the list of concerns is access to capital. Vincenzo Morelli, Chairman of the EVCA, says bank funding for the mid-market has shrunk dramatically in Europe amid tougher regulation and capital constraints, and new sources are needed. ‘Mid-market companies need risk capital to grow, to restructure, to position themselves in new markets or consider large new investments,’ he says.

**Funding for growth**

In the UK, the government has stepped in to boost lending from non-traditional channels. Matched by private sector capital, the government is investing £1.2bn in the mid-market through its Business Finance Partnership initiative. Alcentra, a subsidiary of BNY Mellon, is one of the fund managers taking part.

Graeme Delaney-Smith, Head of European Direct Lending and Mezzanine Investment at Alcentra, observes a desire in the mid-market to move away from a ‘cookie-cutter approach to lending’ to a more balanced funding model. ‘The development of the institutional market into the European middle-market will provide an interesting outlet for companies and private equity sponsors who sometimes want more flexibility than banks are able to give,’ he says.

The launch of Rantum Capital earlier this year is further proof of this appetite. Rantum plans to issue subordinated loans in the range of €2m to €20m to mid-market firms and differs from private equity in that the entrepreneur retains control. The firm says the volume of interest from the Mittelstand has been overwhelming: ‘There is big demand in corporate Germany for equity-like financing. Many of the Mittelstand’s “hidden champions” are market leaders in their specific niches.’

Private equity also has a role in driving European mid-market prosperity. In addition to requiring funding, Morelli says, mid-market companies often need governance, management and the operational support that private equity provides. And on average, private equity makes its best returns from the mid-market. Morelli describes it as a ‘marriage made in heaven’. ‘Private equity is the obvious channel that will be able to continue to provide risk capital to SMEs and it’s already the case for around 22,000 companies in Europe,’ he says.

Private equity investment can also boost the creditworthiness of mid-market companies in the eyes of more traditional lenders. To grow their company with debt finance, founder entrepreneurs can be forced to put up personal guarantees, effectively mortgaging their businesses and their personal lives. Such guarantees are often removed when private equity steps in. Lenders also tend to be more willing to provide funding to a business that has institutional ownership – one that brings increased financial rigour and deeper pockets.

Unlocking Europe’s mid-market potential is increasingly seen as crucial to reviving the broader economy. As the banks’ role as traditional funders of the mid-market recedes, the sector will rely on new sources of capital – creating opportunities for institutional funders and real-money investors looking for attractive returns in an evolving European economy.
Europe’s opportunity

Worries about European growth persist. By contrast, the US is much further down the deleveraging road and confidence is returning. Private equity can help Europe catch up, says Conor Kehoe, Director at McKinsey & Company

Europe traditionally houses some of the world’s leading export-orientated companies – engineering firms in Germany’s famed Mittelstand and their equivalents in the Nordic region, France and Italy, for example. But like most advanced economies, services and local manufacturing and construction dominate European output.

Unlike the US, Europe is a patchwork of national regulation – and perhaps over-regulation. This can reduce competition. UK hotels, for example, operate at well below US productivity levels: strict planning laws mean fewer new formats are developed. Similarly, many professional services are protected. As a result, opportunities to secure the benefits of scale in procurement, use technology more effectively and employ better management practices are thwarted. The net effect of this product-market regulation is lowered European productivity. European output per head was at one stage reaching US levels. It stopped catching up around 2005 – and has since fallen further behind. Despite this, stock market performance is fine, and without the threat of competition some managers may grow complacent.

Enter private equity. While private equity ownership does not change product-market regulation, it seeks improved performance with more urgency than many listed companies. And management are rewarded as owners. The extra productivity comes through simply applying practices from the more productive US markets.

Is there evidence for this? Research by McKinsey and the London School of Economics shows that management practices are consistently more advanced in private equity-owned firms than in other forms of ownership. And the outperformance in returns to shareholders relative to the stock market seen in European private equity is explained by better margin expansion than seen in quoted firms – and higher growth than in quoted firms (Kehoe and others, McKinsey Quarterly, 2005 onwards). This requires skilled engagement from the private equity firm. Management selection and incentives are not enough. Private equity partners must work closely with management and they must be appropriately skilled.

In the end, the winners will be Europe’s citizens. Higher productivity will lead to higher incomes and ultimately more jobs.
Caught in the middle

Middle-market companies are too big to enjoy protection from unwieldy regulation and too small to afford help to deal with it. How can policymakers free them up to grow?

Across Europe, start-ups benefit from policy initiatives and exemptions, designed to encourage their growth. Large corporates have fewer such benefits and zero exemptions from compliance with rules and regulations but they have the resources to cope with this burden.

Small businesses have access to advantages such as tax credits and research and development incentives, but mid-market companies are disqualified as soon as they outgrow that definition.

Karsten Langer, Partner, The Riverside Company

Mid-market businesses enjoy neither the regulatory and tax benefits of small companies, nor can they draw upon large legal and accounting teams to cope with the regulations affecting them.

‘Small businesses have access to advantages such as tax credits and research and development incentives but mid-market companies are disqualified as soon as they outgrow that definition,’ says Karsten Langer, a Partner at global private equity firm The Riverside Company and former EVCA Chairman.

‘The irony is that these measures are designed to help companies become successful and grow but as soon as they do the benefits disappear. If they are not successful and stay small, then they continue to enjoy the benefits – it’s a complete contradiction.’

Germany’s example

Langer cites Germany as the best example of a government in the EU supporting the mid-market. The country understands, he says, that its mid-market companies – the Mittelstand – are engines of economic growth. Advocates of the model (see box, opposite) say that only by encouraging these established firms with proven product lines and demand and concrete customer bases, can Europe drive itself past the prevailing recessionary winds.

New rules governing the financial services industry have made institutions less willing to lend

Philippe De Backer, MEP

Red tape and lack of access to capital are two issues middle-market companies often point to as hurdles to growth.

On the first, Langer argues that in a handful of European countries, governments have achieved a fine balance between employer flexibility and employee security. ‘The two things are not necessarily contradictory,’ he says.

Sweden was one of the first countries to institute equal employment laws for both men and women. It introduced paid parental leave in 1974 and later passed additional employee-friendly laws. At the same time, flexible working contracts have grown in popularity, giving
employees more control over their work-life balance and employers greater flexibility in the way they manage their companies.

Mid-market employers are not necessarily calling for less red tape, says Langer, but they do want regulation to be constructive and implemented in the least onerous way possible.

Access to capital
Mid-market companies also need more day-to-day access to capital. Banks were the traditional lenders but they are taking a more cautious approach to lending in the wake of the 2008 financial crisis. Philippe De Backer, a Liberal MEP with a background in venture capital, believes the role of the EU is to support schemes at the national level to encourage high street banks to lend again.

‘Since the beginning of the financial crisis there have been many new rules governing the financial services industry, which have made institutions less willing to lend. The European Commission addressed some of these in its Green Paper on long-term investing,’ De Backer says. ‘The EU is also trying to take its share of the burden through the work of the European Central Bank and the European Investment Fund, both of which have created schemes to help small businesses get access to the money they need.’

De Backer concedes there is work to do on communicating these schemes to business owners, particularly headline programmes such as Horizon 2020 – a research and innovation initiative that is part of a drive to create growth and jobs in Europe. Opportunities are missed regularly because business owners are unaware of the incentives available or the administrative burden is hampering access. It is vital to create the right incentives and support for companies throughout their lifecycle. Whether it is providing adequate financing or removing regulatory hurdles, policymakers’ support for the entrepreneurship eco-system is essential.

International expansion
Another missed trick, according to Langer, is a lack of concrete support for businesses that want to become international by exporting their goods or setting up branches in parts of the EU. Global expansion is a key characteristic of successful middle-market companies.

‘The first thing we must do is finish the single market; this would be a big help for exporting companies,’ Langer says. ‘There are still different regulations for many different products across Europe, so we can’t be like the US and trade easily across one market.’

Access to finance, government support, tax breaks and help with exports all form the wish list of Europe’s businesses breaking out of the SME bracket. By acknowledging the mid-market’s strength and ability to deliver growth and employment in the real economy, policymakers can help to pull the region out of its current economic malaise.

The Mittelstand model

Mittelstand companies:
> Are export orientated
> Focus on innovation
> Produce high-value manufactured products
> Hold global leadership positions in their respective niche segments
> Are privately owned
> Tend to be based in small rural communities
> Take a cautious and long-term approach
> Use modern management practices, such as employing outside professional management; and implementing lean manufacturing practices and Total Quality Management
> Work closely with universities and researchers
> Cluster around large manufacturers
> Benefit from Germany’s apprenticeship system, which provides skilled workers

The Mittelstand model

1. Stable economic environment
2. Skilled and educated workforces
3. Increasingly global outlook
4. Protected by highly evolved legal systems
5. Source of regular patents and general innovation

Five reasons to invest in Europe’s mid-market

1. Stable economic environment
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5. Source of regular patents and general innovation
At Belgian manufacturing company Magotteaux, private equity supporters were able to identify and realise its hidden potential.

It took a keen eye for detail and extensive research for private equity firm IK Investment Partners to grasp Magotteaux’s hidden potential. Finding rough diamonds like this in the mid-market is key to achieving long-term economic growth.

Based in Liège, Belgium, Magotteaux manufactures and sells wear-resistant grinding products and associated services for ore processing, cement processing, recycling plants and power stations.

At the time of IK’s investment* in 2007, Magotteaux had a solid customer base but lacked a professional structure able to achieve the company’s international potential.

Bernard Goblet, who was appointed Chief Executive of Magotteaux a year before IK’s investment, saw that his first job was to structure the business for growth. “The first thing IK did was help us professionalise the management team,” Goblet says. “The idea we had was to create a real worldwide group with this investment. I had previous experience with a private equity firm so I knew how the process worked. IK was chosen because we wanted a real industry partner, not just money. IK was very professional in the way it had analysed the business and spotted its market potential. It had assessed the sector and our competition, and was very flexible in how it dealt with us.”

The pull factor

The strongest pull factor for IK was Magotteaux’s expertise and passion. “The Magotteaux team was very knowledgeable and the business was market-leading in cement in Europe and the US,” says IK’s Deputy Director Bart Borns. “The team was passionate about communication in the cement markets. We convinced them to extend their passion to the mining markets and to business excellence. They did not have the same attitude to operational excellence, nor did they look beyond their industries for opportunities and economies of scale. There was quite a journey between the buying and selling moment; we took their market-leading technology in cement and applied it to the mining industry with great success.”

IK’s value-creation strategy was designed to realise Magotteaux’s full potential. The investment team brought systems for financial reporting up to standard and improved cash flow. It also introduced ‘lean’ manufacturing processes, boosting operating efficiency, trimming the supply chain and reducing the amount of capital.
tied up in inventory and ‘work-in-progress’ projects. The business was reorganised to place a greater focus on end-markets and individual business units were made more accountable.

The local Walloon government owned 10% of Magotteaux and, as a shareholder, proved valuable in helping IK implement improvements, says Borms. For example, it helped connect Magotteaux to the right people when seeking government permission to build a new plant in Strepy, Belgium. The highly automated facility created local jobs and was part of €120m worth of capex projects Magotteaux implemented during IK’s watch. A significant majority of that capex budget funded expansion into emerging markets, such as Thailand and China, and created 300 jobs across the company.

The company’s R&D efforts were concentrated in Belgium. When IK invested in Magotteaux, it found 100 R&D projects in progress but little had come to market in the previous five years. IK changed the company’s R&D mindset, helping it to focus on a handful of projects with commercial potential. During IK’s investment period, Magotteaux spent approximately €40m on R&D and successfully took 10 new products to market.

IK also strengthened the company’s headquarters in Belgium, adding finance and sales functions. Historical ties and a knowledgeable, skilled and loyal workforce meant Belgium would continue to be the springboard from which to grow the business.

In 2011, IK sold its majority stake in Magotteaux – a mutually agreed exit – to Chilean mining group Sigdo Koppers. By then, the business had grown to €500m turnover and witnessed a 15% increase in headcount to 2,500 staff across 26 office locations.

Spotting mid-market opportunities takes a great deal of due diligence, even before the investment is made. IK understood Magotteaux’s technological capabilities and its potential beyond its existing markets. It also refocused the business on international growth markets, backed by major investments in expansion, while executing operational improvement programmes. Because of this, IK’s investment was a success.

*The investment in Magotteaux was made by IK’s IK2004 Fund.

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**Five characteristics of high-performing mid-market companies**

- Established customer base
- Proven demand for product or service
- Scope to expand into new markets
- Year-on-year revenue growth
- Ambitious international outlook
Private equity can play a significant role in transforming the fortunes of middle-market companies, helping them to drive Europe’s economic growth.

The £15m acquisition of European aerospace components supplier Gardner Group in 2010 was private equity firm Better Capital’s first-ever investment. Before this, Gardner was experiencing major declines in demand for its business jet and truck transmission products. It had old factories and was running its sites individually rather than as an integrated business. Three years on and it has achieved improvements in quality, delivery and financial performance. The business is growing at approximately 20% a year and staff numbers have more than doubled from 600 to 1,500.

**Struggling companies**
While the majority of mid-market companies such as Gardner have performed well for decades, the number that are struggling has risen in the wake of the financial crisis. Business transformation specialists can help to turn them around.

For many of these specialists, the mid-market sector is where they can help to make a real difference to businesses as swiftly as possible.

Tyrone Courtman, President of the European Association of Certified Turnaround Professionals, explains: ‘Turnaround in the SME and lower mid-market sector is more challenging, as you are often working with family owners and entrepreneurs who have a deep emotional attachment to the business and aren’t always receptive to third-party advice.’ Large companies require large investments, it takes longer to drive change and the result is less pronounced, says John Arney, Managing Partner of European transformation specialists Arle Capital. Mid-market companies tend to have grown large enough for owners to loosen their emotional ties while retaining the flexibility of small firms.

**The Better way**
Better Capital looks for distressed businesses and often invests within five to 10 days of meeting a management team. ‘We try to move in quickly, take away the business’s debt and introduce our operational expertise and stronger management to sort it out,’ says Nick Sanders, the firm’s Head of Portfolio.

The acquisition of Gardner Group is one of Better Capital’s success stories. Immediately after the investment, Sanders’ team and the Gardner management got to work to update workshops, integrate sites, operationally restructure the management board and improve customer experience.
relationships. Two investments – RD Precision and Blade Tooling – delivered growth. More recently, the firm acquired French aerospace group Airia and its subsidiary Financiere Maz’air through a new company, Gardner-Airia Holdings. It also purchased a 70% stake in Bangalore-based Pranita Engineering Solutions.

‘Our investment has taken Gardner Group from a dishevelled business and turned it into a market leader. It’s a complete transformation,’ says Sanders. ‘Today Gardner is strategically well placed. It has good factories in the UK, in France, two in Poland and one in India. Now it’s about continuing to win business.’

Good to great
Private equity is more than a lifeline for mid-market firms in distress. It can also turn an existing stable business into an entity that is bigger, better and more profitable. One example is Expro, an international oilfield services provider backed by Arle Capital in 2008.

Headquartered in the UK and spanning 50 countries, Expro had strong credentials at the time of investment but had suffered during the economic crisis. One of Arle’s most significant contributions was to strengthen Expro’s management team. In 2010 Charles Woodburn, of Schlumberger, the world’s largest oilfield services company, was appointed CEO and in 2012, Sir George Buckley, former Chairman, President and CEO of conglomerate 3M, became Chairman. This new level of expertise and a refocused strategy, alongside the sale of non-core parts of the business, a series of acquisitions, investment in new products and a $250m capex injection, have led to positive results for the company, including earnings growth of more than 40%.

‘We have transformed Expro from the company that we delisted from the London Stock Exchange in 2008,’ says Arney. ‘We will continue to grow the company and expect continued double-digit growth. It is possible that we will re-list the business when we feel the time is ready.’

Over the past two decades, Arle has led 25 investments and realised 21 of these to return €3.9bn to investors. Its secret? ‘We favour the mid-market sector as the place to find businesses that are sufficiently robust at one end yet small enough at the other so that you can make a real difference,’ says Arney.

We favour the mid-market sector as the place [where we] can make a real difference

John Arney, Managing Partner, Arle Capital

What private equity brings to the table

Arle Capital Managing Partner John Arney tells us why he thinks private equity can make a difference in Europe’s middle-market:

A desire for change
‘Private equity professionals bring with them the desire to challenge the status quo in order to build value.’

World-class people
‘The Arle partnership contains, and can access, some of the world’s best PE-savvy industrialists and we can deploy these individuals into businesses which might not ordinarily be able to attract such talent.’

Clear agenda for value creation
‘Private equity brings a finite period of time to achieve change, usually within a three- to seven-year period. You have to make good decisions if you are going to create value.’
The EVCA is the voice of European private equity.

Our membership covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. We represent 700 member firms and 400 associate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is responsible for the industry’s professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.

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