KEYNOTE INTERVIEW

Capturing growth in a dislocated market

With the crisis leaving European SMEs starved of capital, there will be significant opportunity for growth stage deals when the time is right, say ESO Capital's Alex Schmid and Steve Edwards

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Q How will the covid-19 crisis impact Europe's SME sector?

Alex Schmid: It is impossible to predict, but we expect to see second wave shutdowns across various countries and regions. And, of course, everything is connected. Travel will continue to be very difficult and economic activity will stop and start as companies get their bearings. The sheer level of noise and uncertainty is likely to make businesses very gun shy when it comes to taking risks.

Steve Edwards: Most companies have gone into lockdown of some description and they are taking advantage of government schemes as best they can. That means they will come out of this with more leverage, and credit will be stretched because they will not have been paying suppliers, and they may have deferred tax payments.

As we move into a recovery phase, that will start to strain balance sheets. Even high-quality companies will find themselves under working capital pressure, so there is going to be a real need for capital.

Q Will the current dislocation provide opportunity?

SE: These are unprecedented times. But this is the ESO team's fourth economic cycle and while each downturn has unique characteristics, there are also common threads.

What tends to happen, is that traditional sources of capital migrate to safe havens or else sit the downturn out. Meanwhile, the SME world, which is relatively underserved at the best of times, becomes even more starved of capital. And this downturn is particularly sharp – it is unheard of for so many countries to go into lockdown at the same time and the hit to economic activity will be acute.

AS: Capital flows do tend to follow a similar pattern when a crisis occurs. First, significant downturn is felt in the public markets. There is an immediate hit on capital allocations and, as a result, capital flows out of other areas to fill that public markets hole.

The second stage comes when smart investors start to think about the downside opportunity, which always seems to pull capital flows from international markets into the US, because that is the most active distressed market.

Next is the move from smaller alternatives into bigger alternatives, because investors want to benefit from scale.

We focus on non-sponsored, small to medium-size companies that tend to become capital starved because it can take a long time for capital flows to return to normal. We therefore believe there will be a very significant opportunity in our segment.

Q Where are those opportunities likely to come from?

AS: That is very difficult to judge. Our franchise looks at fundamentally healthy companies where there is some sort of complexity that, for whatever reason, makes more traditional capital providers shy away. Those characteristics can exist in any industry and in any of the Northern European countries where we invest.

I think there will be opportunities throughout our market, but it does take some time for those to be flushed out. You do not want to be too early, especially this time around. We envisage that there will be a number of episodes to this crisis and we want to be sure we are not stepping into a marketplace that has another downturn to come.

Q What sorts of complexity may make a business attractive to you but not to other lenders?

AS: A business may often present risks if you look at it quickly, from a checklist perspective. Those risks may be real, or they may be perceived. We focus on situations where on a headline basis there is an issue that makes banks worry. That issue may also worry us at first. However, after spending a lot of time digging through the details, we may find that what seems like a risk on paper, is not actually that significant.

For example, we completed one deal where the company had a customer concentration of 80 percent and for that reason the deal did not work for

Q How do you look to drive growth in the SME sector?

SE: One of the reasons that the SME sector is so attractive, is that a well-structured business with an ambitious management team and a focused business plan – with the benefit of external capital – can really grow rapidly. Organic growth tends to be a more significant feature than for larger companies that are more driven by market share and GDP. It is not uncommon for our businesses to deliver 20 percent organic growth because they have got the space to do so.

From the company's point of view, our capital can help them reach those growth rates. From our point of view, that growth de-risks us, bringing our multiples of lending down and accelerating the opportunity for us to refinance. That said, it is also very common for us to put in additional funding, usually for acquisitions.

"Even high-quality companies will find themselves under working capital pressure"

STEVE EDWARDS

many other counterparties. But this was a solid business, delivering significant profit. Our solution was structured at two times EBITDA leverage and additional upside through a minority equity stake. Those are the deals we look for – complex situations which provide us with arbitrage on risk versus return.

SE: In that company's case, we looked at what would happen if the main customer cancelled the contract on day one. We realised that we would get our capital back because of the way the contracts were structured and the way the cashflows worked. Although the optical risk looked high, in practice, we were covered. It is about understanding the risks and structuring capital accordingly.

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>
> **ALEX SCHMID**

Q What else do you look for in a business?

SE: We look for high quality businesses where management teams are in charge of their own business models, rather than commodity businesses where pricing in the global markets is going to impact a business in a way that the management team cannot control. There may be all sorts of reasons as to why those businesses are coming to us, particularly that they do not like the alternatives. For example, the somewhat formulaic approach to bank lending may not suit them or they may want to avoid equity dilution from standard private equity funds.

Q Have SME attitudes not evolved beyond that resistance to ceding majority ownership?

SE: We tend to work directly with founders and entrepreneurs. I have never actually met a founder who is keen to give up equity. First, there is the economics of it. They are in it for the upside and they are not very time sensitive as to when that money comes. They usually have a particular sum that they want to make for themselves and they don't mind if they wait three, five or even 10 years to hit that number. Then there is the psychological aspect. Giving up control is a big deal. I think it is less of an issue in the UK market than it once was, but there is still a barrier there. Our flexible capital solutions effectively negate the need for management teams and founders to give up as much equity and usually do not involve them giving up control.

But I also think it is a question of the definition of control. We structure our deals with loan notes that come with covenants. We make sure we have the control we need to keep our capital protected and then deliver equity value for us through some sort of exit or refinancing. Control probably means different things to us than it does to the entrepreneur.

Q What sorts of entrepreneurs do you like to work with and what approach do you take?

SE: We are looking for people for whom their business is their life's work. They want to stick with it but are looking at a certain opportunity or growth that requires external capital, usually for the first time. We help them transition from introverted, fully-owned entities, to having an outside financier – someone else on the board to talk to, who has a lot of experience helping businesses get to that next level. Ultimately, we look to create a more valuable, institutionalised company that is ready for exit, if and when the company decides to go down that route.

AS: Our capital is structured as debt but has equity-like features. We are first in the capital structure, taking a credit return, but then we take an equity return after that. It is a hybrid solution. Because that capital has an asymmetric return profile, if an owner really delivers on their business plan, their return is going to be significantly higher than under private equity ownership. If performance is average, their return will be on a par with private equity and if they under-deliver, because of our debt solution, their return will be lower. All that means, we are really targeting optimistic owners that believe in the deliverability of their plan and are committed to it.

Q What growth stage deals have you done recently?

SE: One example is Pyroguard, a UK-based manufacturer of fire-resistant architectural glass. ESO Capital backed a management buyout in 2018. The existing management team became majority equity shareholders, while ESO director David Steel also joined the board. The deal was structured as a senior-secured loan note with additional equity participation. Pyroguard used the investment to accelerate its expansion plans domestically and in Europe. It completed a bolt-on acquisition in the first year and now has locations across France, the Netherlands and Spain, with one of the widest product ranges available. ■

Alex Schmid and Steve Edwards are both senior partners at ESO Capital