Performance Equity Management

The Argument for Small and Middle Market Buyouts

- *Secular trends have expanded the private equity opportunity set, particularly in the small and middle market buyouts space (companies with enterprise values below $500M).*
- *Small and middle market buyout funds may potentially outperform given they can bring significant hands-on operational improvements to their portfolio companies.*
- *These companies can also often avail themselves of higher EV/EBITDA multiples upon exit as they grow and diversify their businesses.*
- *Manager selection, however, is critical as there is a wide dispersion between top and bottom performing funds.*
- *Co-investing with small and middle market buyout managers can not only serve to lower fees and accelerate deployment but can also provide an in-depth look into managers' processes, enhancing selection.*
- *Of course, building a successful small and middle market buyout portfolio is not without its challenges. Successful buyout managers often raise larger funds, leading to the need for constant re-evaluation of a portfolio of managers in the space.*

PERFORMANCE
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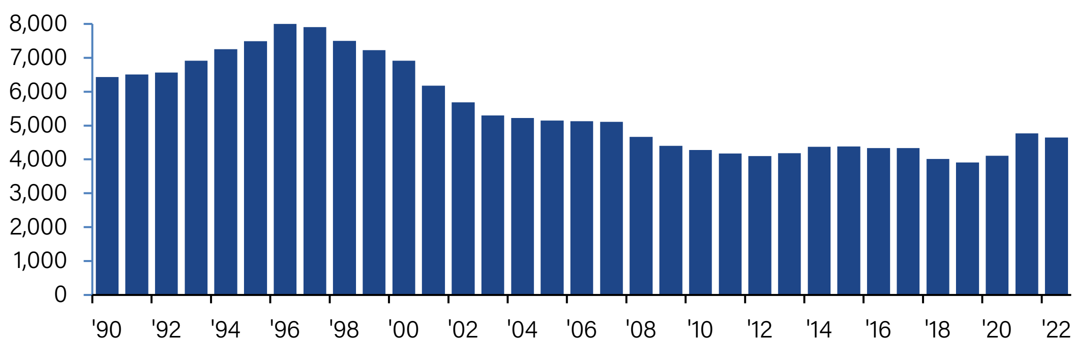
The Small and Middle Market Buyout Opportunity

Dedicated exposure to small and middle market buyouts is a critical component of a well-diversified private equity portfolio that seeks to generate alpha.

The landscape for private equity has evolved over the last forty years, most importantly in the small and middle market buyouts space as important secular trends have expanded the opportunity set. For example, since the 1990s, the number of listed U.S. companies has declined substantially (Figure 1).

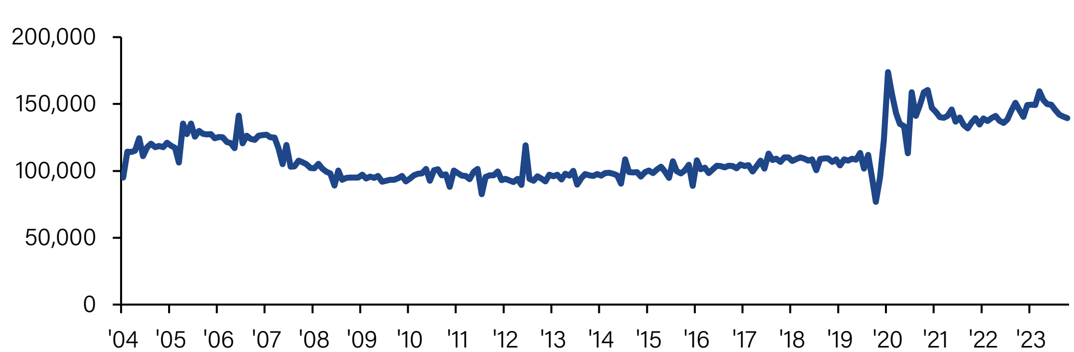
Figure 1: Listed U.S. Companies



Source: World Bank, World Federation of Exchanges, as of December 31, 2022.

Many companies are opting to go or remain private given the increasing availability of private market funding and the growing regulatory burden associated with public listings. Concurrently, the pace of new business formation following the onset of the pandemic, particularly among small and mid-sized companies, continues to be robust (Figure 2).

Figure 2: Applications for Business Formation (High-Propensity Businesses)

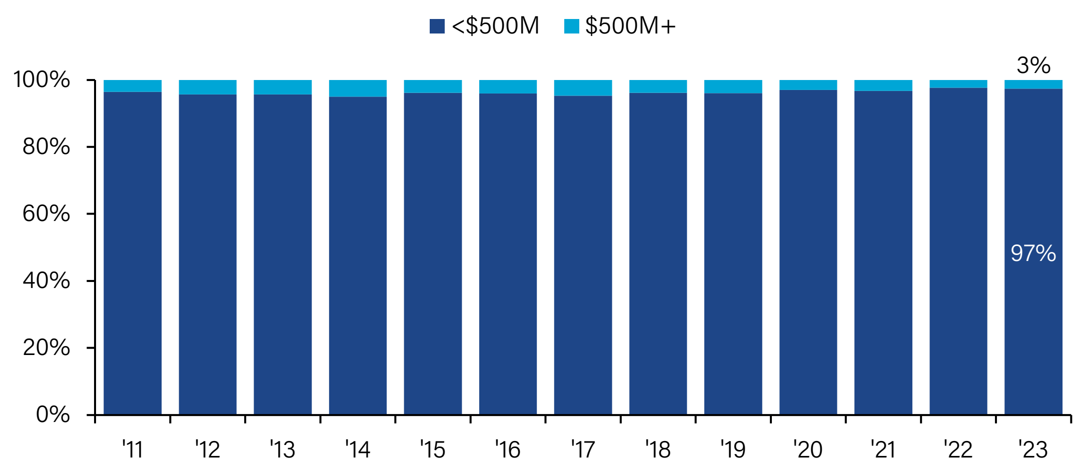


Source: Census Bureau, as of April 30, 2024. The Census Bureau defines high-propensity businesses as those that have a higher likelihood of becoming businesses with employees and payroll capabilities.

The Small and Middle Market Buyout Opportunity (cont.)

Over 95 percent of buyout deals in the U.S. occur with companies with an enterprise value of less than $500 million (Figure 3). The universe of available deals is wide and varied, allowing for highly skilled managers to identify the most attractive companies through economic cycles and across sectors.

Figure 3: Share of U.S. PE Deal Count by Company Size



Source: PitchBook, as of December 31, 2023.

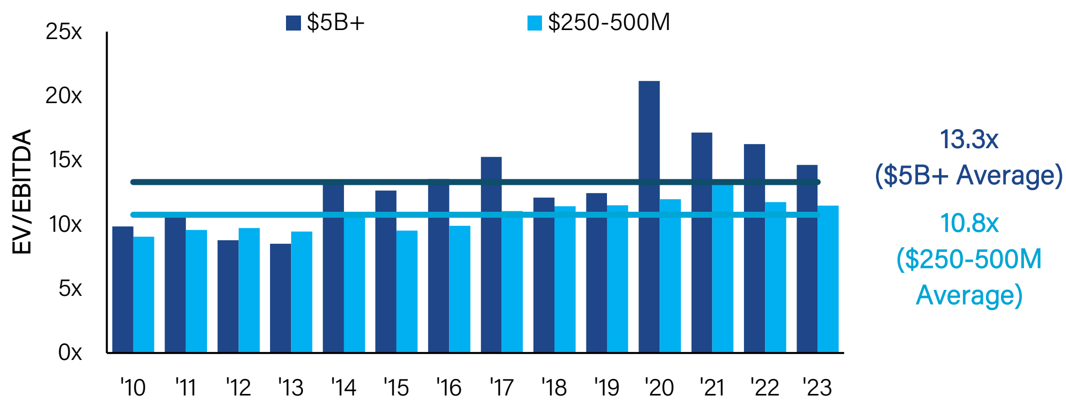
The Small and Middle Market Buyout Opportunity (cont.)

Within this private equity opportunity set, small and middle market buyout funds generate compelling returns through several important mechanisms.

1. Lower Entry Multiples

First, we find that small and middle market buyout funds acquire companies at lower EV/EBITDA multiples than do large funds (Figure 4).

Figure 4: EV/EBITDA Entry Multiple by Fund Size of Global Buyouts



Source: PitchBook, as of December 31, 2023.

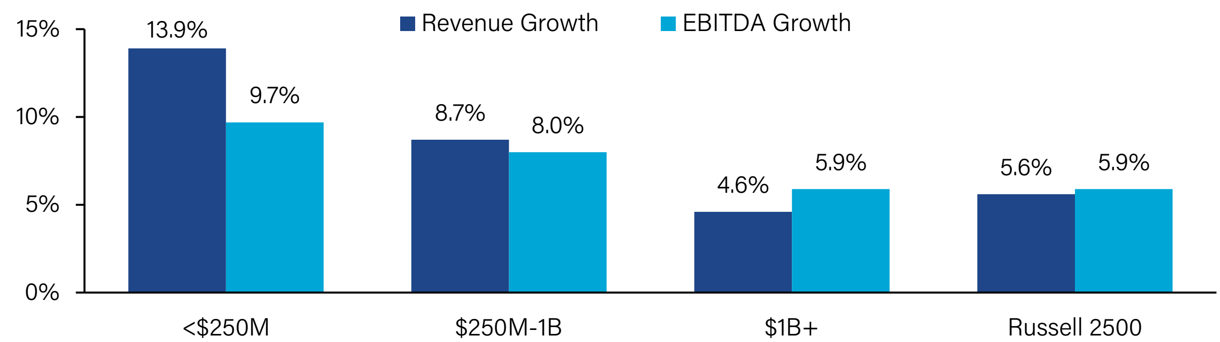
Given the smaller average investment size, the expansive universe of available targets and the less pervasive sell-side coverage of small and middle market companies, discussions between funds and owners are more often on a proprietary basis. At times, these funds are the first institutional capital into founder-owned businesses. This contrasts with the competitive, auction-driven processes that can result in large buyout funds paying higher entry EV/EBITDA multiples. Firms that are successful in growing these businesses to a larger scale often avail themselves of higher EV/EBITDA multiples upon exit, thus taking advantage of the structural difference in purchase prices based on the size of business.

The Small and Middle Market Buyout Opportunity (cont.)

2. Hands-on Operational Improvements

Moreover, as early capital into these businesses, small and middle market buyout funds, which tend to be specialized, can implement significant hands-on operational improvements. These can be in the form of organic growth initiatives, including building existing products, expanding the customer base, or entering new geographies. As a result, these smaller companies experience higher rates of growth (Figure 5).

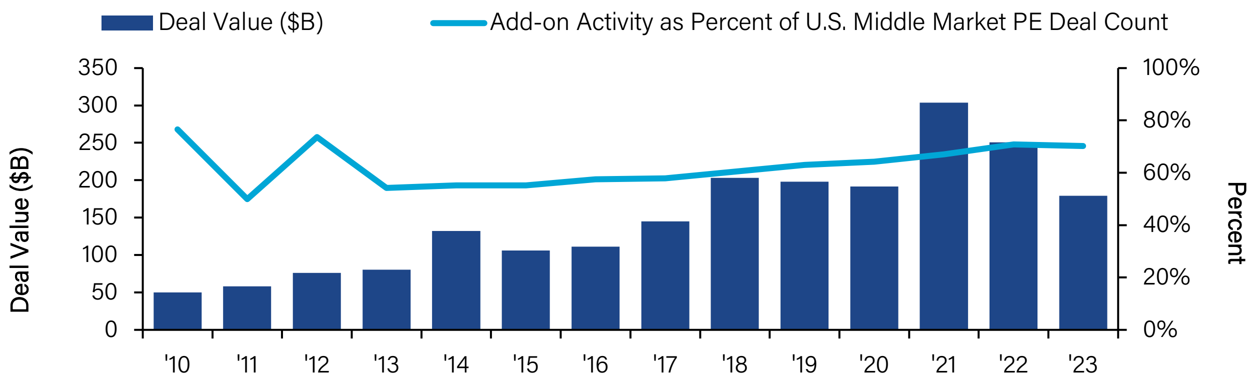
Figure 5: U.S. PE Average Annual Revenue and EBITDA Growth by EV (2008-2020)



Source: Cambridge Associates Private Investments Database, FactSet, Frank Russell, as of December 31, 2020. Operating metrics reflect averages as of December 31, 2020, and outliers were identified and excluded from calculations. Sample includes unrealized and realized U.S.-based buyout and growth equity companies acquired in 2000-2020. Public company growth and margin figures are based on the calendar years 2008-2020.

Value creation can also be in the form of "add-ons," in which a private equity fund buys a platform portfolio company to which it strategically adds complementary businesses. A well-executed add-on strategy can add significant value over the life of an investment and represents a sizable portion of the private equity market (Figure 6).

Figure 6: U.S. Middle Market PE Add-on Activity



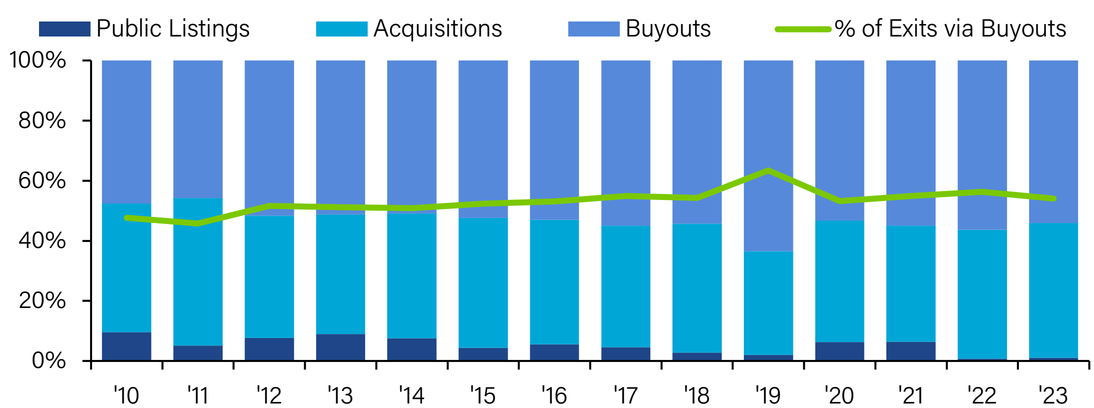
Source: PitchBook, as of December 31, 2023.

The Small and Middle Market Buyout Opportunity (cont.)

3. Exit Optionality

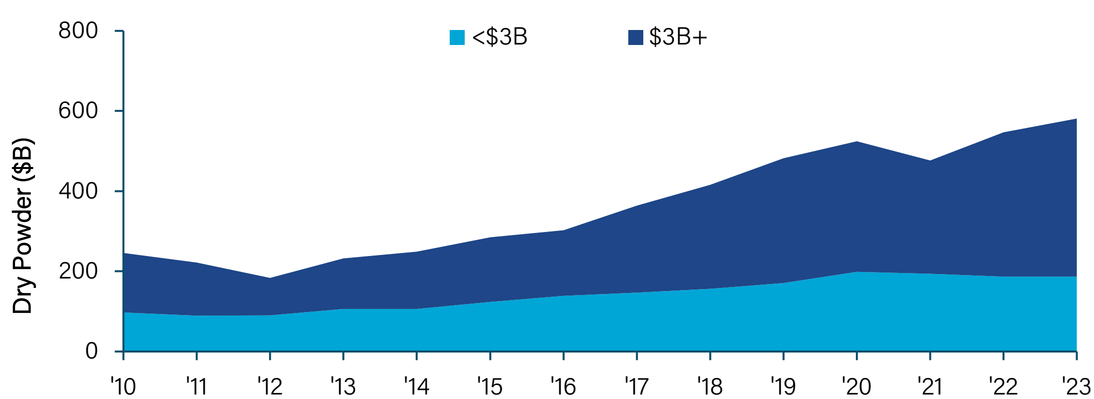
In terms of exit options, large buyout funds play a critical role in the ecosystem: companies can be purchased not only by strategic acquirers, but also by larger private equity sponsors. In select market environments where public listings occur less frequently, this exit optionality can be especially valuable. This trend has become more important over the last decade as sponsor-to-sponsor transactions have increased from 48% in 2010 to 54% in 2023 (Figure 7), fueled by the increase in dry powder for larger buyout funds (Figure 8).

Figure 7: U.S. Middle Market Buyout Exit by Type



Source: PitchBook, as of December 31, 2023.

Figure 8: U.S. Buyout Dry Powder by Fund Size

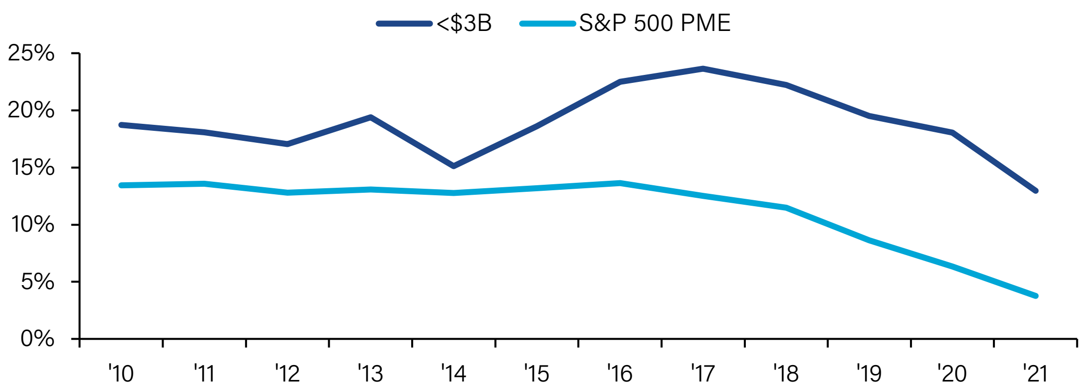


Source: PitchBook, as of December 31, 2023.

The Small and Middle Market Buyout Opportunity (cont.)

As a result of these factors, investors have seen strong returns over the last decade as small and middle market buyout funds have generated outperformance against their public market equivalent (Figure 9). Over the period from 2010 to 2021, funds under $3 billion in size have outperformed the S&P 500 by an average of over five hundred basis points.

Figure 9: Buyout Performance vs the S&P 500 Public Market Equivalent (mPME)



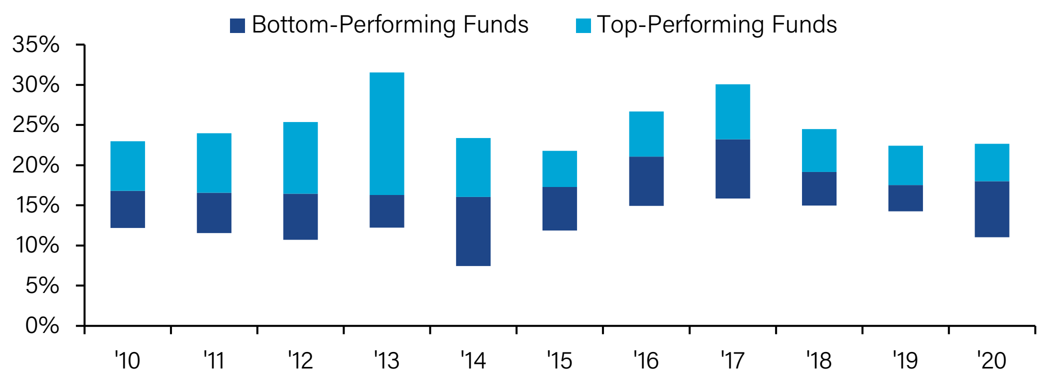
Source: Cambridge Associates, as of December 31, 2023. Cambridge Associates mPME is a private-to-public comparison that evaluates what returns would have been achieved had the dollars invested in private investments been invested in public markets instead.

The Small and Middle Market Buyout Opportunity (cont.)

4. Portfolio Construction

As with many private market strategies, manager selection is critical. Small and middle market buyout funds offer high potential for return enhancement given the wide dispersion in returns between top-performing and bottom-performing funds (Figure 10). According to Cambridge Associates, for vintage years between 2010 and 2020, the average dispersion between top quartile and median performance was seven hundred basis points. Over this same period, the average top quartile IRR exceeded 25%.

Figure 10: U.S. Buyout Manager Dispersion for Funds < $3B



Source: Cambridge Associates, as of December 31, 2023. Data is net to Limited Partners.

There are several key characteristics that distinguish top-performing small and middle market buyout funds, which can be assessed through investment and operational due diligence processes. This includes investing in industry leaders with clear, focused investment strategies with demonstrated prior track records.

Co-investing with small and middle market buyout managers can also enhance understanding of their processes. Importantly, this requires depth of experience as these managers tend to have faster processes and require more frequent decisions for follow-on capital. As with large buyouts, co-investments with small and middle market buyouts are also a means to lower fees and to accelerate capital deployment. Finally, the co-investment process offers the opportunity to express conviction in the fast-growing sectors or themes to which small and middle market buyout managers may have unique access.

The Small and Middle Market Buyout Opportunity (cont.)

Challenges

Of course, building a successful small and middle market buyout portfolio is not without its challenges. Successful buyout managers often raise larger funds, leading to the need for constant re-evaluation of a portfolio of managers in the space. A dedicated team with demonstrated success in building and maintaining a consistent portfolio of small and middle market buyouts over time is essential to generating long-term alpha.

The high dispersion seen in Figure 10 creates a tremendous opportunity for outperformance, but also the chance for underperformance. While the average spread from top quartile to median managers is over seven hundred basis points, the average spread from median to bottom quartile managers is over six hundred basis points. The small and middle buyout universe carries more risk given product concentration, less mature senior management teams, and competition from more well-capitalized competitors. Without consistent and demonstrated selection ability, performance suffers.

Summary

Small and middle market buyouts are an increasingly critical component of a well-diversified private equity portfolio though manager selection continues to be key. Co-investments alongside these managers can be critical in building relationships with top performing funds as well as in enhancing returns through lower fees.

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