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Small and Middle Market Buyouts

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Over the last 20 years, buyout managers targeting the lower end of the market - private companies with enterprise values of $500 million or less - have consistently outperformed public equities while performing in-line with other buyout strategies. This lower end of the buyout market has also historically generated a wider performance spread relative to that of other buyout strategies. The objective of this paper is to examine the sources of those returns and expectations for their persistence in the future.

The range of sizes and types of businesses pursued by buyout managers is very wide, from single-store retail franchises to large industrial businesses valued in the tens of billions of dollars. Over the course of the 1980s, the buyout market evolved to target large businesses, and since that time the largest end of the buyout market has dominated the attention of investors and the press. Large buyout groups such as The Blackstone Group, KKR, and The Carlyle Group, each of which have been capable of raising pools of capital of more than $10 billion every two-to-four years,[1] make frequent appearances in the popular press. Many of the companies they target, such as Safeway, PetSmart, ADT Security, and Hilton Hotels are well known to most people. Due to this familiarity, as well as other considerations that includes compelling long-term performance, large- and mega-market buyout groups have also garnered tremendous interest from long-term investors.

However, despite the highly institutionalized nature, strong and lengthy track records, and deep resource bases of most large- and mega-market buyout managers, the small- and middle-market buyout ("SMMBO") space (i.e., companies with enterprise values below $500 million) may offer a superior investment opportunity. While large- and mega-market transactions receive most of the media attention, roughly 80% of buyout transactions globally over the last 10 years have had transaction values of $500 million or less.[1] This is illustrated in Figure 1.

The SMMBO category is a broad market set that offers a much larger number of opportunities for managers to identify potentially attractive deals. Further, due to the generally limited sophistication of management teams at smaller businesses, a large opportunity often exists to generate value through enhancing operations. Finally, additional value can often be created through exiting smaller market investments, as there is a larger set of potential buyers and a persistent valuation gap between small and large businesses that benefits investors in a company that has reached larger scale.

[1] Source: Preqin, as of November 2022.

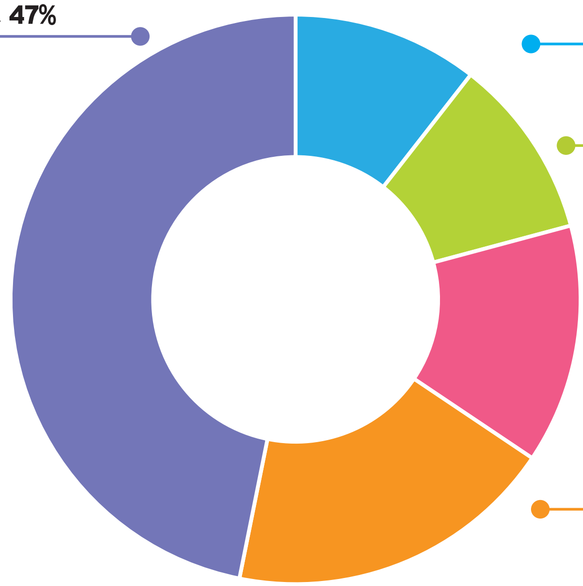

FIGURE 1
Global Number of Buyout Deals Over the Past 10 Years by Value Band

Source: Preqin, as of November 2022.

The private equity investment opportunity

There are several factors on which investors typically focus when deciding to invest in private equity. The first is the relative inefficiency of the private markets. There is less broadly available information, a condition that creates more opportunity for large spreads between transaction pricing and what a fully efficient market would likely bear.

The second factor is the ability for private equity managers to improve the companies in which they invest by being a "control" investor. Investors in public equities are typically passive owners of the businesses, with ownership stakes that represent a small percentage of the companies' total equity and little influence over key business decisions. In contrast, private equity investors can often take an active role in the oversight and management of a company in which they invest, thus effecting potentially value-added changes to a company's strategy, management team, and capital structure. Control also allows for greater alignment of interest between the owners and management than is common for most public companies. Further, control often provides an owner more information with which to decide when and how to exit an investment most profitably.

Finally, the long-term, illiquid structure of private equity vehicles provides flexibility to make changes that may be costly in the short term but have the potential for significant gain over a long holding period. By contrast, the management of publicly traded companies are commonly under pressure to show incremental gains on a quarterly basis.

Market landscape

While the large end of the buyout market includes only a few dozen managers, all of which are relatively well known to most investors with private equity programs, the universe of SMMBO managers is very large and challenging to navigate. The universe of investment opportunities for SMMBO funds represents a large segment of the buyout market, with nearly 208,000 companies in the US producing annual revenues of between $10 million and $500 million.[2] An estimated 2,900 managers are currently targeting the buyout space in the US, the majority of whom target small- and mid-size companies for investment.[3] In the last 10 years, 73% of buyout funds raised in the US were in the small and mid-market range.[4]

[2] Source: NAICS Association, as of February 2022.

[3] Source: Preqin, as of November 2022.

[4] Source: Cambridge Associates via IHS Markit as of Q2 2022. Fund Count by Vintage Year as of December 31, 2021. Data sourced in October 2022. Indices used: Cambridge Small Market Buyout, Mid-Market Buyout, Total US Buyout Market.

While the opportunity set for SMMBO managers is very large and segments of it remain relatively inefficient, the large number of managers in the space has made it increasingly competitive. This natural evolution of the space has forced managers to adapt their strategies over time to increase their effectiveness and continue to generate superior returns despite increasing competition. Due to this dynamic, many SMMBO managers have sought to develop capabilities that provide competitive advantages, of which the most common are listed below:

→ **Operational expertise:** As SMMBO managers generally seek to both grow and improve the businesses in which they invest, some have sought to hone this capability through developing expertise in operating small- and mid-sized businesses. Various models have been developed for this purpose, ranging from creating loose affiliations with individuals who have operating backgrounds (e.g., former CEOs and COOs), to building out large, dedicated teams of operating professionals to work alongside the investment staff.

→ **Deal sourcing:** While less common due to the increasing intermediation of the SMMBO market, some buyout firms have sought to develop enhanced deal sourcing capabilities. Nearly all SMMBO firms seek to develop proprietary deal flow and dedicate some time and resources to this effort. Some, however, have sought to make deal generation a material competitive advantage through systems and professionals that are dedicated to this purpose. Others have sought to enhance deal flow through affiliations with institutions, like investment banks or other intermediaries.

→ **Industry specialization:** Many SMMBO groups specialize in specific sectors of the market, most commonly healthcare, technology, media, energy, financial services, and consumer/retail. There is a wide spectrum of specialization, with some firms focusing on only one sector, while others specialize in a handful of areas. Such firms believe that this specialization provides access to unique transactions, improves the effectiveness of due diligence, and allows them to provide portfolio companies with valuable resources.

Historical performance

Historically, investors have been rewarded for investing in SMMBO funds, as they have consistently been among the best performing segments of the private equity markets. Over long time periods, SMMBO funds in the US have generated a premium over public equities and produced returns in line with larger buyout funds. Since 2000, Rolling 10-year returns for SMMBO strategies have been higher than large- and mega-market buyout ("LMMBO") strategies and the Russell 3000 by an average of 0.9% and 5.5% per year, respectively, as shown in Figure 2 below.

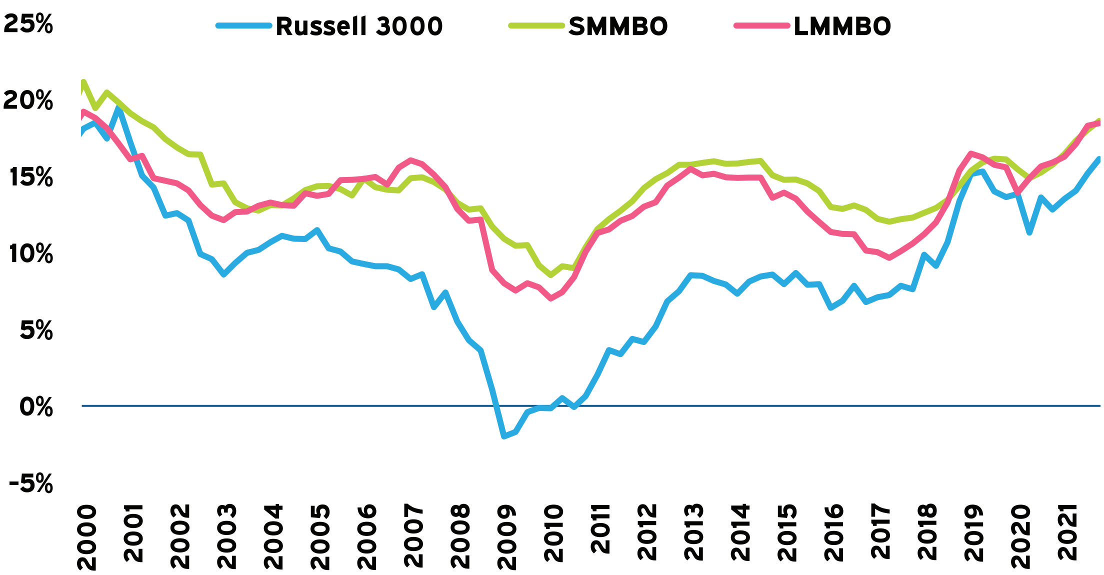

FIGURE 2
Rolling 10-Year Performance

Source: Cambridge Associates via IHS Markit as of Q2 2022. Rolling 10-Year Annualized Returns as of December 31, 2021. Russell 3000 data sourced in November 2022, SMMBO & LMMBO data sourced in October 2022. Indices used: Cambridge Small Market Buyout, Mid-Market Buyout, Large Market Buyout, Mega Market Buyout, and Russell 3000. Note that Small & Mid-Market Buyout (SMMBO) and Large & Mega Market Buyout (LMMBO) are a combined weighted average of IRRs based on fund count. Note that all historical performance presented throughout this document is net of fees.

SMMBO's performance premium over LMMBO and the Russell 3000 has been trending downward in recent years. Notably, the spread between SMMBO and the Russell 3000 is still positive but has returned to around its level prior to the Global Financial Crisis ("GFC").

The performance of small market buyout funds has exhibited significant dispersion of returns, both across time and among funds of any given vintage year. As detailed in Figure 3, there is a considerable spread between the performance of the top quartile small market fund, the median fund, and the lower quartile fund. The average interquartile spread for US small market buyout funds with vintages 2000 through 2019 was 16.5%. This figure is higher than other types of buyout funds as the average interquartile spread for all US buyout funds over the same period was 14.0%. Many of the best performing vintages of the last 20 years have been those during and immediately following economic contractions. The considerably high performance of vintages in the early 2000s and later that decade immediately followed business cycle troughs from the "dot-com" and GFC market contractions, respectively. This is likely the result of such funds forming during times of relatively low purchase valuations as well as general improvements in the business cycle providing a "tailwind" during the holding periods of the underlying investments.

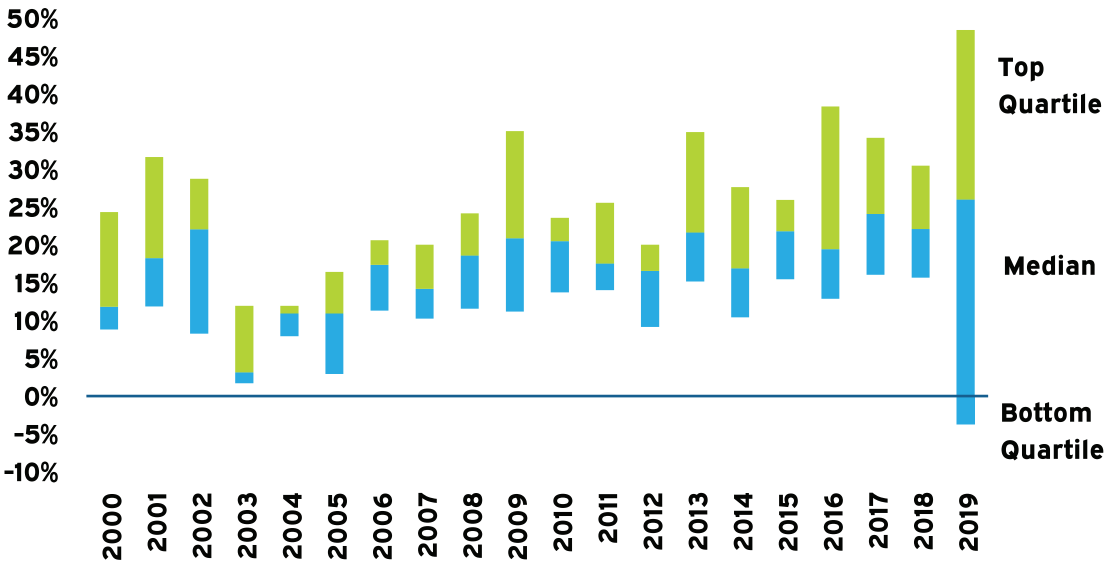

FIGURE 3

Small Market Buyout Interquartile Spread by Vintage Year

Source: Cambridge Associates via IHS Markit as of Q2 2022. Data for Small Market Buyout funds raised since inception (1986) through December 2021. Data sourced in October 2022. Vintage Years 2021 and 2020 are excluded as they are too recent. The graph represents Small Market Buyout funds only as there is not enough Mid-Market fund data to construct a weighted SMMBO graph. Fund count 349.

Figure 4 below depicts the interquartile spreads of weighted SMMBO and LMMBO funds since inception. The spread between the top quartile and median for weighted SMMBO funds of vintages 1986 through 2021 is 9.8% while the spread between the median and bottom quartile is 6.6%. This wide return dispersion implies there is significant room for managers to add value or, conversely, detract from it.

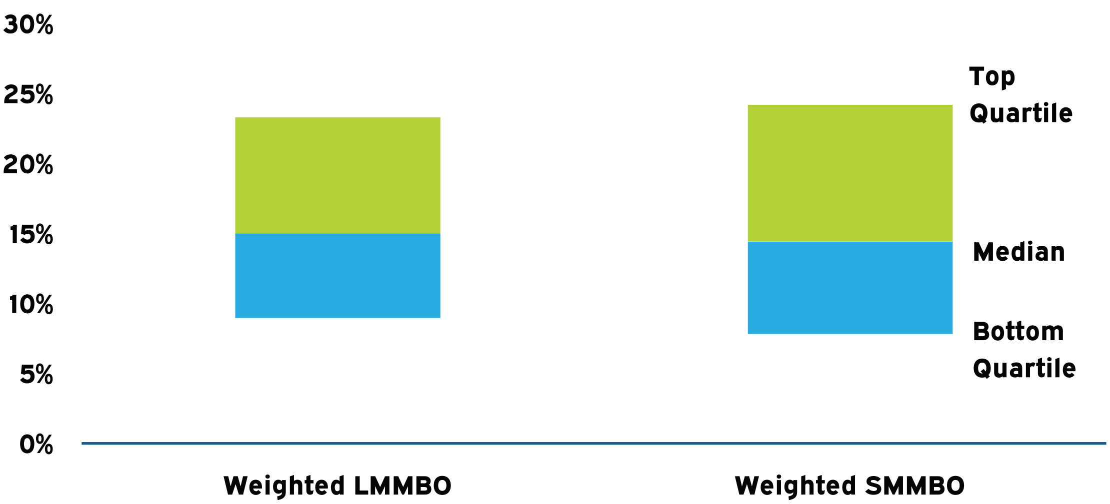

FIGURE 4

Weighted SMMBO and LMMBO Quartile Spread Since Inception

Source: Cambridge Associates via IHS Markit as of Q2 2022. Data for small-, mid-, and large-market buyout funds raised since inception (in 1986) through December 2021. Data for mega-market buyout funds raised since inception (in 1994) through December 2021. Data soured in October 2022. Note that small & mid-market buyout (SMMBO) and large & mega-market buyout (LMMBO) are a combined weighted average of IRRs based on fund count. SMMBO fund count 747. LMMBO fund count 310.

Figure 4 also shows that SMMBO funds have a larger spread than that of LMMBO funds. Since inception, the interquartile spreads of SMMBO and LMMBO are 16.4% and 14.3%, respectfully.[5] A larger interquartile spread implies that the SMMBO space has greater opportunity for alpha compared to LMMBO funds. Therefore, manager/fund selection is an especially critical element of investing in SMMBO funds in order to participate in the wealth creation capacity of the asset class and receive commensurate compensation for the more significant risks involved with the strategy.

[5] Source: Ibid.

Advantages

While the strong performance of SMMBO funds has been persistent and observable over time, its causes are more difficult to characterize. Due to the lower asset base and less stable earnings relative to larger companies, less leverage is typically used, meaning the performance of SMMBO transactions appears to be less dependent on financial engineering. Anecdotal evidence indicates that the sources of returns for any individual transaction may vary widely. Within a given SMMBO manager's portfolio, the investment theses may vary from one deal to the next, relying alternatively on revenue growth, margin expansion, distressed purchase pricing, or favorable industry or capital market dynamics as drivers of investment performance. However, the means by which SMMBO managers generate investment performance appear to be a distinct advantage for the strategy in that they are numerous and, to a large degree, possible to execute in most market environments. The following section provides a detailed description of the various advantages of the SMMBO approach.

Valuations

While data for the pricing of private market transactions is sparse, the available data suggests that SMMBO transactions generally occur at lower purchase multiples on average than for the large and mega buyout market. For the period 2007 to 2018, none of the years had transactions where the SMMBO purchase multiple exceeded that of the LMMBO.[6] For the same period, the average spread between Small and Mid-Market and the Large and Mega-Market was 1.7x.[7]

While many factors contribute to this pricing spread, one primary factor for these relative discounts is that there are fewer financial intermediaries that serve smaller companies. In addition, there are fewer avenues available for these companies to raise capital on their own. Consequently, competitive SMMBO managers are frequently able to identify transactions with limited or no competition, or to otherwise identify companies for which they can negotiate attractive pricing.

[6] Source: Pitchbook, "LCD's M&A Stats," as of September 30,2022. Small & Mid-Market is a weighted average based on deal count, note that some years do not have Small Market data and thus only Mid-Market multiples were used for those years. Small & Mid-Market represent purchase price under $500M. Large & Mega Market represent over $500M. All PPM figures include fees/expenses.

[7] Source: Ibid.

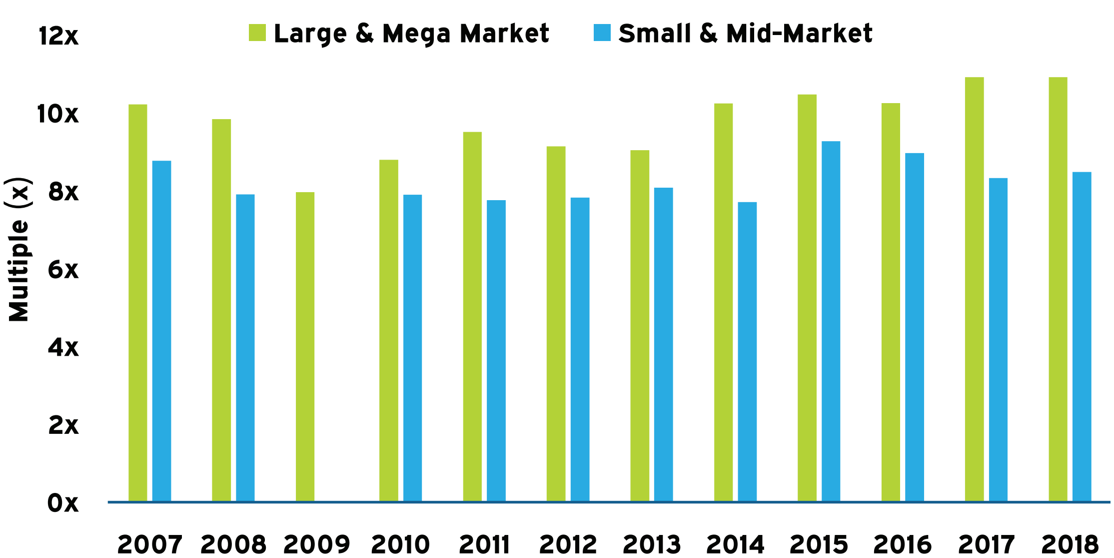

FIGURE 5

Buyout Purchase Price Multiples

Source: Pitchbook, "LCD's M&A Stats," as of September 30,2022. Small & Mid-Market is a weighted average based on deal count, note that some years do not have Small Market data and thus only Mid-Market multiples were used for those years. Note that 2009, 2019, 2020, & 2021 are not included as too few deals were tracked for the combined SMMBO universe to be meaningful. . . Small & Mid-Market represent purchase price under $500M. Large & Mega Market represent over $500M.

Broad opportunity set

With roughly 208,000 small- and mid-sized companies just in the US, the universe of SMMBO investment opportunities is broad.[8] This larger universe will naturally lead to vast differences in the types and quality of companies being considered. This allows SMMBO manager to be selective when evaluating investment opportunities.

[8] Source: NAICS Association, as of February 2022.

Value creation

The sophistication, networks, and resources of small- and mid-sized private companies tend to be less developed than for larger organizations. Similarly, they are less likely to be using industry best practices in a number of areas, to be using leading edge software for functions such as finance, accounting, and human resources, or to have sought advice from management consultants. Hence, the companies in this space often have much greater room for improvement.

SMMBO managers have sought to apply their resources to enhance portfolio companies and increase shareholder value. Such enhancements may be achieved through several avenues, including the development of new products, growing market share, effectively monitoring and managing costs, institutionalization of processes, and increasing scale. Competitive SMMBO managers have demonstrated an ability to achieve such enhancements by augmenting or changing management teams, providing strategic advice, improving corporate governance, bolstering financial reporting and operating processes, and introducing the company to new potential customers, distributors, and suppliers. Due to the small size of companies in the SMMBO space, many more opportunities exist to affect such value creation strategies than in larger businesses that are typically more heavily resourced and efficiently managed.

Multiple expansion via growth

Companies that have more stability of earnings, higher margins, and better growth prospects generally command valuations at higher multiples of earnings, all else being equal. Successful SMMBO managers frequently use this dynamic to their advantage by helping companies grow in size, either organically or through acquisitions, such that they are more attractive to potential acquirers and investors and thus command a higher multiple of earnings upon exit than at acquisition. This approach of building out from a "platform" company, often deemed "buy and build," has been a common strategy for many SMMBO managers.

Exit flexibility

Relative to other private market investments, SMMBO investments have more potential avenues for creating liquidity at the end of an investment's holding period. Similar to venture capital, SMMBO investments, once mature, are expected to be of a size where they would be attractive to large strategic buyers or be candidates for initial public offerings. One additional channel of liquidity uniquely available to SMMBO-backed strategies is financial buyers (e.g., other private equity funds). SMMBO investments are typically of the size at maturity where they become attractive candidates for large- or mega-market buyout funds with substantial resources that allow them to seek even greater company growth, operating efficiency, or financial engineering.

Disadvantages

Despite the advantages previously described, SMMBO strategies have several disadvantages that merit attention and may limit their appeal to certain investors.

Target company quality

Relative to larger market transactions, companies in the SMMBO market generally have lower caliber management teams, fewer resources with which to weather business or market challenges, and often compete with larger, more effective firms. Additionally, many of the sources of value creation in SMMBO strategies, such as reducing customer concentration, changing management teams, and growth through acquisition, involve commensurate risks. Further, a failure to successfully execute a SMMBO investment strategy may involve a greater loss of capital relative to a larger market buyout investment, as smaller companies generally have relatively fewer non-core assets to provide a cushion against losses.

Manager quality & migration

Many managers that generated successful track records in the SMMBO space gradually shift their focus to larger transactions. This transition of many successful SMMBO funds to larger fund sizes means that limited partners who want to maintain a dedicated allocation to SMMBO will have to be constantly scouring the space for new GPs.

High relative cost

Smaller funds, all else equal, generally involve higher per-unit costs. As the basis for calculating management fees (aggregate commitments during the investment period) is lower for smaller funds, SMMBO funds generally charge a higher rate of management fees in order to generate enough current income to offset the costs of the resources used to execute their strategies.[9] These higher rates can result in a wider expected spread between gross and net performance for SMMBO funds relative to larger buyout funds, all else equal.

[9] Source: Preqin, "2022 Global Private Equity Report," as of January 2022. The average Annual Mean LP-Reported Fees Paid during Investment Period (as a % of Commitments) for SMMBO is 1.6%, LMMBO is 1.3%.

Size mismatch for large investors

There are several considerations that may impact investors' willingness or ability to commit capital to SMMBO funds. First, limited partners with sizeable programs or concentrated strategies may experience challenges accessing SMMBO funds due to the managers' limited capacity to accept large commitments. Many managers seek to limit any single investor to no more than between 10% and 25% of total commitments. Second, relative to larger managers, many SMMBO groups have less institutionalized processes and familiarity with the reporting and governance requirements of institutional investors.

Dry powder

Dry Powder, or capital that has been committed by investors but not yet "called" (e.g., used for a specific investment) has been on the rise over the past decade for all sizes of buyouts (see Figure 6). Buyouts, in general, have the highest amount of dry powder compared to other strategies in private equity.[10] This is due to the strategy's nature as buyouts require more capital to purchase companies, unlike venture capital and growth equity which infuse capital into companies without buying them outright.

[10] Source: Preqin, as of November 2022.

SMMBO targets the smaller side of the buyout universe and as such, their deals require less dry powder than LMMBO deals. Despite accounting for roughly 80% of all US buyout deals in the past 10 years, transactions under $500 million only accounted for 25% of aggregate deal value.[10] This means that, as expected, more deals are occurring with small- and mid-size companies and at a lower purchase price (see Figure 5 for differences in purchase price multiples). LMMBO deals tend to be more expensive and therefore require more time to fundraise. This can result in investors' capital sitting for longer periods without being invested.

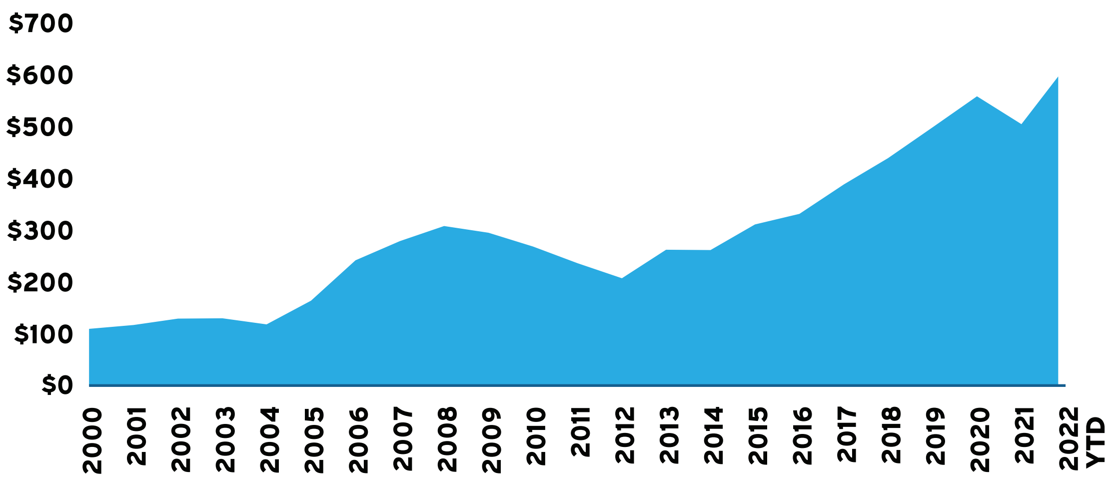

FIGURE 6
US Buyout Dry Powder ($B USD)

Source: Preqin, as of October 2022.

There are differing views on whether more dry powder is a negative or positive sign for investors in the buyout market. For example, some believe an increase in dry powder signifies there are not enough deals available for the amount of capital allocated to the market. Pressure from LPs to put this dry powder to work could result in less disciplined deals being made and cause investors to take on higher than normal risk and experience lower returns.

On the other hand, some argue that more dry powder is not inherently bad as it enables investors to pursue attractive opportunities whenever they arise, as well as provide additional cash to companies already in the portfolio, if needed. For example, higher dry powder levels among LMMBO funds could translate into more capital available to purchase portfolio companies held by SMMBO funds. A high level of dry powder can also offer extra protection during times of turbulence in the market, helping enable investors to "weather the storm". Further, during market downturns, when fundraising is more difficult, a higher level of dry powder may allow GPs to be opportunistic and take advantage of deals that may be attractively priced.

Summary and recommendation

Due to the size of the SMMBO market opportunity and the predictable need for companies to partner with knowledgeable and well-resourced managers that can help them drive growth and operational efficiency, the SMMBO space makes for a strong cornerstone of private equity portfolios. Historically, investors have been rewarded for their allocations to SMMBO strategies as such funds have, in aggregate, outperformed public market indices while keeping pace with other buyout strategies over long time periods. Meketa Investment Group believes that the drivers of this strong performance typically reside in strategic advantages enjoyed by SMMBO managers that are not universally shared by other private equity strategies. These advantages include exploitable market inefficiencies, potential for multiple expansion, more options available for generating liquidity, and, most importantly, numerous methods by which to create tangible, extractable value in portfolio company investments.

Investing in SMMBO funds, however, also involves risks and other considerations for certain investors. Most notably, the small- and middle-end of the buyout market, by its very nature, involves investment in relatively smaller and less stable companies, and partnering with managers that are generally less well-resourced and less sophisticated than larger buyout groups. While average returns have been nearly indistinguishable from LMMBO, SMMBO has exhibited a larger performance spread historically. Thus, the SMMBO space likely offers greater potential for skilled managers to generate alpha. We believe this dynamic creates opportunities for experienced and capable SMMBO managers to differentiate themselves and execute repeatable, value-added strategies.

Appendix

The definitions of small, mid, large, and mega cap companies continue to evolve over time and can be based on transaction value or revenue metrics. There are no standard industry-wide classifications, managers and investors use their own individually determined ranges. However, there are general industry ranges that vary from broad to narrow. One such variation is in the middle market, which historically has represented up to $500 million, but some have recently begun to shift it upward to represent up to $1bn in enterprise value.

	Narrow Range	Broad Range
Small Market Range	< $50	< $25
Mid-Market Range	$50 - $500 Lower mid-market: $10 to $250 Middle mid-market: $250 - $500	$25 - $1,000 Upper mid-market: $500 - $1,000
Large & Mega Market Range	> $500	> $1,000

FIGURE 7
Classification Ranges by Enterprise Value ($M USD)

Source: Bain & Company, "Global Private Equity Report 2022." and Pitchbook, "US PE Middle Market Report Q2 2022."

	1986-1994 ($)	1995-1996 ($)	1997-1999 ($)	2000-2004 ($)	2005-Present ($)
Small Market Range	< 100	< 200	< 250	< 350	< 750
Mid-Market Range	100 - 500	200 - 500	250 - 750	350 - 1000	750 - 2000
Large Market Range	> 500	500 – 1000	750 – 1000	1000 – 3500	2000 – 3500
Mega Market Range	N/A	> 1000	> 1000	> 3500	> 5000

FIGURE 8
Classification Over Time by Market Cap ($M USD)

Source: Cambridge Associates via IHS Market, "Cambridge Associates Private Equity Family: Index Methodology," as of June 2022.

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