Private Markets - A Case for the Lower-Middle Market

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Headlines within the private equity space may be dominated by names like Blackstone and Carlyle, but there is often more opportunity within the lower-middle market (defined here as companies with enterprise values below $250 million). With greater access to deal flow, promising growth potential, and more flexible exit options, the lower end of the market can be highly attractive.

Mr. Searing suggests three key advantages to investing in the lower-middle market:

An Inefficient Market

In the United States, there are approximately 22,000 companies with revenues exceeding $100 million while there are over 175,000 companies with annual revenues between $10 million and $100 million[1].

There are clearly fewer potential investment opportunities in the larger end of the private equity market. In addition, these companies are usually represented by large investment banks or sell-side advisors due to their size and revenues. This dynamic creates a more competitive and efficient deal making environment, typically leading to higher purchase price multiples.

Not only are there more target companies available for investment in the smaller end of the private equity market, there is less capital pursuing these companies as well. According to Preqin, North American leverage buyout funds with $500 million or less in commitments have $37.3 billion of capital available for investment while funds with over $1 billion in commitments have $260.3 billion available[2]. The significant investable universe, the lack of broad coverage from Wall Street advisors, and less capital targeting these companies creates favorable supply and demand dynamics that often result in lower purchase price multiples.

As industry data shows, the 10-year average purchase price multiple for leveraged buyouts of businesses with enterprise values below $250 million was 7.3x trailing twelve months earnings before interest, tax, depreciation, and amortization ("EBITDA") as compared to 9.0x trailing twelve months EBITDA for all leveraged buyouts over the same period[3]. Paying a reasonable price for a quality business is an important skill for a private equity firm, and a critical element of their investment strategy. Based on the dynamics of the industry, this is often more feasible at the smaller end of the market.

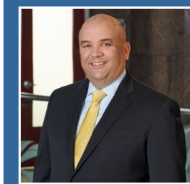
Opportunity to Increase EBITDA

Many lower-middle market companies are run by the founder and/or family that owns the business. An investment from a private equity firm is often their first exposure to institutional capital. While these businesses may have successfully operated for years, there is often significant opportunity to professionalize the businesses by enhancing management and financial reporting, increasing operational efficiencies, expanding the geographic footprint and product offerings, and investing in sales and marketing efforts. Private equity firms may also act as an outsourced merger and acquisition consultant,

[1] U.S. Small Business Administration - Statistics of U.S. Businesses, Business Dynamics Statistics, Business Employment Dynamics, and Nonemployer Statistics – 2012

[2] Preqin Dry Powder Report US/North American Buyouts – August 2016

[3] S&P Capital IQ M&A Stats – April 2016



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Mr. Searing joined DuPont Capital in 2002 and is currently a member of the Private Markets Group investment team responsible for partnership selection and portfolio management. Mr. Searing focuses on Buyouts, Special Situations, and Private Credit in the U.S. and Europe.

As part of his role at DuPont Capital, Mr. Searing is a member of numerous limited partner advisory boards. Mr. Searing has also been invited to and participated in a number of industry conferences.

Mr. Searing earned a Bachelor's degree in Business Administration and an M.B.A. from Villanova University, and is a CFA charterholder.

The lower-middle market is typically characterized by a large number of target companies, less capital pursuing them, and little institutional representation, creating favorable supply and demand dynamics for investors.

offering their expertise in identifying and ultimately purchasing attractive complimentary businesses. These efforts can generate significant growth potential to small businesses that were previously under-managed.

Multiple Exit Options

If the private equity firm's investment is successful, a business that was generating $5 to $10 million of annual EBITDA can grow to $15 million or more after a three to five year time period. This increase is a function of organic growth as well as the aforementioned acquisitions. In addition to the observable growth in revenue, these businesses are more efficient and professionalized making them highly attractive to a broader range of potential acquirers. Such buyers include larger private equity firms, as well as strategic acquirers. A public listing ("IPO") is also a potential exit option for businesses that have seen more substantial growth. The bottom line is once companies have grown above $10 million of annual EBITDA, the population of potential acquirers increases dramatically. In contrast, larger companies with enterprise values above $500 million may be more reliant on a fickle IPO market.

Mr. Searing also points out other ancillary benefits to the lower-middle market:

1. **Straightforward Capital Structure.** Businesses within this space have a relatively simple capital structure with financing provided by only one or two banks. The lender(s) tends be a relationship banker with an interest in the business succeeding. As a result, there is less risk of losing the business to multiple debt suppliers if the business starts to struggle in an unfavorable environment.
2. **Better Alignment of Interests with the Private Equity Firm.** Lower-middle market private equity firms tend to have greater alignment of interests with their investors. Many of the larger private equity firms have evolved into global asset managers with numerous investment vehicles pursuing a variety of strategies. Lower middle-market private equity firms tend to be smaller with a focused strategy, typically a single buyout fund, so incentives are more aligned.

The results speak for themselves. The 10-year upper quartile net IRR return for Small Leverage Buyout Funds is 19.0% compared to 14.2% for Mega Leverage Buyout Funds over the same time period. While both areas of the market certainly offer a return advantage over traditional fixed income and equity asset classes, the lower middle-market offers greater opportunity to capitalize on inefficiencies within the space.

[4] Burgiss/Private IQ Buyouts returns as of March 31, 2016; Small Buyout Funds are less than $500 million of commitments; Mega Buyout Funds are $4.5 billion or more of commitments.

There is often better alignment of interest between investors and lower-middle market private equity firms due to their smaller size and the narrow focus of their strategy.