

US small buyouts: Exploiting inefficiencies in the world's most efficient economy

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While the US remains the best run economic machine globally, attracting high levels of capital, market efficiency and capital overabundance are typically not ideal conditions for return generation. The US buyout space in particular is experiencing record high valuations at the large end of the market and record fund raising. However, there is a bifurcation of the market with a less efficient and less overcrowded “long-tail” of hundreds of thousands of smaller companies that offer attractive entry conditions for private equity investors. After having grown to a larger size – often helped by the active intervention of the respective buyout fund managers – many of these companies can benefit from the efficient sales processes and surplus of capital seen at the larger end of the market. A caveat is that finding and managing investments in the “long-tail” of the US company universe is not an easy task.

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A common worry

“Are the best days of US buyouts behind us? Has the market become too overcrowded with capital relative to the opportunity set at a peak time in economic activity?” These are just some of the thoughts keeping limited partners awake at night. Schroder Adveq believes that investors should sleep better; there are still highly attractive opportunities for those willing to do the hard work to find them. US small buyout investments¹ in particular present a compelling opportunity for investors to generate outsized returns and can serve as an alpha-generating complement to a mainstream large buyout portfolio. Highly specialised small buyout managers are able to utilise all of the levers of private equity value creation by capitalising on the

inefficiencies inherent in buying and transforming small US companies. Ultimately they can then sell these businesses into a well-capitalised, highly efficient buyer universe. Successfully investing in the small buyout space requires skill and the appropriate resources due to its scale and scope, so investors should be thoughtful in how they approach the market and construct their portfolios.

The world's most efficient economy

Imagine a perfect setting for buyout investing: robust access to investment capital, business-friendly regulations and strong investor protections, combined with a highly liquid market for buying and selling a business. The US comes closer to this utopia than any other region with leading positions in global GDP, M&A activity, and capital market volume paired with a top 5% “Ease of Doing Business” ranking according to the World Bank.

¹ Small buyout includes funds <USD 2 billion in size and companies with revenues between USD 5-100 million. Large buyout includes funds >USD 2 billion and companies with revenues >USD 500 million.

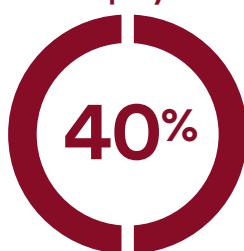
The US combines the deepest M&A and capital markets with a business friendly environment

% of Global M&A Activity



USD 1.4 trillion

% of Global Equity Market Cap



USD 32 trillion

Ease of Doing Business Ranking



#6 out of 190 countries

The attractiveness of the US economy has also made it one of the most efficient markets globally for private equity and has allowed the asset class to generate strong returns for decades. As the market has become ever-more competitive, investors can seek areas of greater inefficiency in order to continue achieving their high-return investment goals. One such area is the US middle market, often referred to as the “engine of the US economy.” This segment represents 50% of US GDP, employs half of the working population and offers a host of exploitable inefficiencies for investors to capitalise on.

Why inefficiencies still exist in US private equity and why they help generate returns

In a purely efficient M&A market, companies are sold for their true value with limited opportunities for arbitrage. At the large end of the US buyout market this is typically the case – most deals are represented by blue-chip investment banks and are marketed through broad auctions and sold to the highest bidder. Fortunately, bargains can still be found in the acquisitions of small US companies. In 2017, the average enterprise value/EBITDA entry multiple for a small company was 7.1x versus 10.9x for a large one².

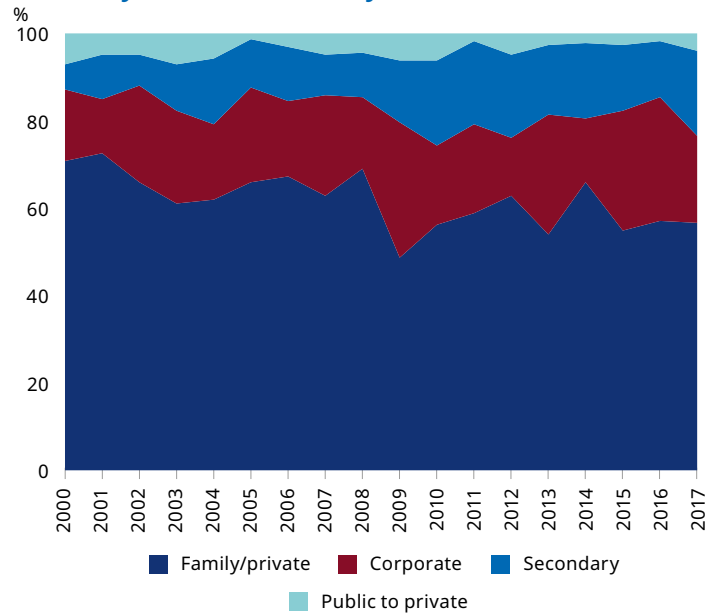
There are several reasons for this divergence in pricing related to the sheer number, geographic spread, and ownership structure of small US companies as well as some of the risks associated with acquiring small enterprises. Specifically, there are over 300,000 small companies dotting the US landscape. This vast market lacks the same intermediary coverage that large companies receive as small company M&A fees are not perceived to be worth a bulge bracket investment bank’s while.

Most small companies are owned by founders and families or are small divisions of larger corporate parents; nearly 80% of small US buyout transactions exhibit this ownership structure prior to investment by private equity. For many of these sellers, price is not always the sole determinant of whom to sell to. Instead, finding the right partner who will be good steward of the business can outweigh pure price considerations alone. These inefficiencies allow small buyout managers to be more selective in their targets and also pay lower prices for their portfolio companies.

² Source: S&P Global Market Intelligence, Baird M&A Market Analysis. EBITDA stands for earnings before interest, tax, and depreciation and amortisation

Small buyout transactions continually sourced from private owners and corporates

Small buyout transactions by deal source



Small buyouts: deals <USD 100 million in enterprise value; large buyouts: deals >USD 500 million in enterprise value. Source: Pitchbook, Schroder Adveq, 2018

These ownership structures also present attractive value creation opportunities. Family-owned companies are often solid businesses but they may not have been run for optimal efficiency and may not have explored transformative growth opportunities due to the risk tolerance, available capital or skill set of an existing owner. Many small divisions of large companies have received less attention due to senior management’s focus on larger drivers of corporate performance. Both situations can benefit greatly from a partnership with a skilled buyout firm experienced in unlocking the potential of a small business.

Where value can be found and created in less efficient parts of the US buyout market

Many specialised small buyout managers have a replicable strategy to address common small company shortcomings. It is not enough to buy “cheap,” cut costs and de-lever as a significant part of the valuation creation often comes from transforming a business to create an entity that the efficient market yearns for but often can’t find or create itself.

Table 1: How specialised managers mitigate typical small company issues

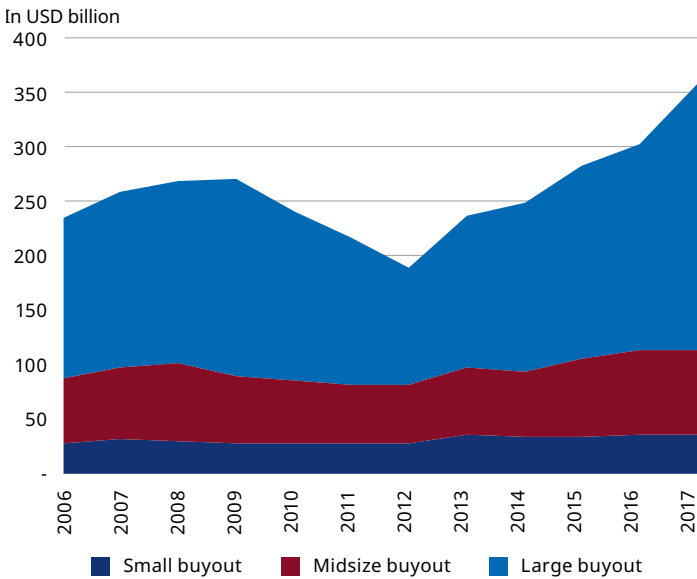
Common small company issues	Specialised small buyout solutions
Customer concentration	Buy and build strategies, new customer introductions
Lack of M&A capabilities	Act as outsourced business development team
Managing for cash	Provide return-on-investment driven investment capital
Hard to attract sufficient talent	Access to blue-chip operators and functional specialists
Weak IT systems	Invest in enterprise resource planning and financial systems, instilling a metric-driven approach

Exiting to the most efficient part of the market

Once the value creation plan has been executed, a deep-pocketed buyer universe awaits. These buyers include cash-rich strategic acquirers and well-capitalised larger buyout firms who will pay high multiples for a growing and successful company. Unlike small buyout fundraising which has been quite stable relative to history, there is increasing pressure on large US buyout funds to deploy the nearly \$250 billion in dry powder they have amassed in recent years.

Large US buyouts have growing pressure to deploy capital

US buyout capital overhang by fund size

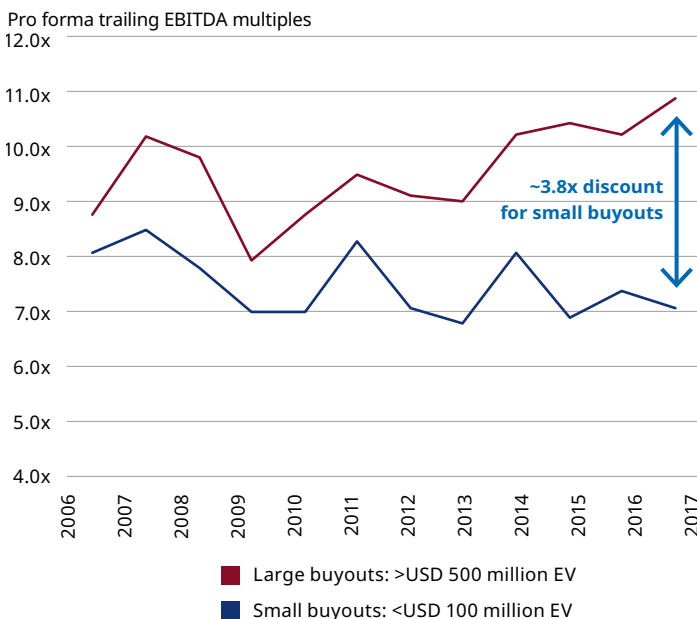


Small buyouts: funds <USD 500m; mid buyouts: fund between USD 500m-2bn; large buyouts: funds >USD 2bn. Source: Preqin, Schroder Adveq, 2018

While there has always been a discount for small company entry multiples relative to large companies, today's market presents one of the widest spreads ever and reflects a compelling bargain opportunity.

Strong fund raising pushed valuations to record levels for large buyouts and offers attractive exit opportunities

EV/EBITDA purchase multiples US small and large buyouts

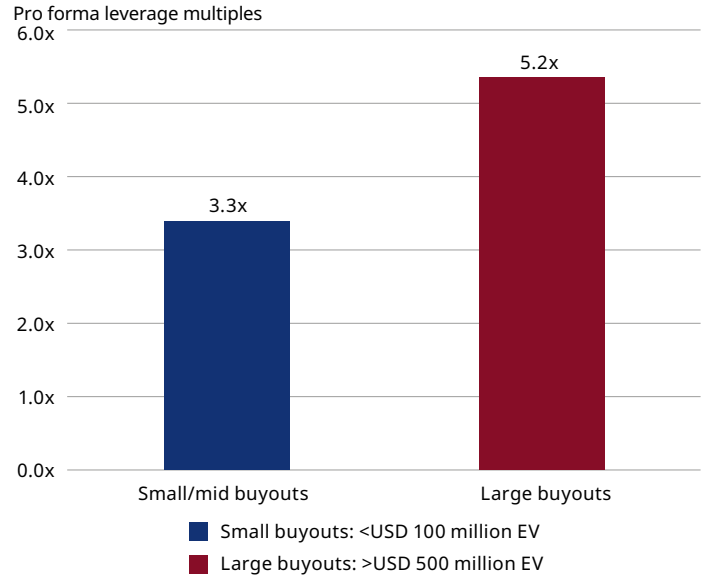


Source: Baird, S&P 2017, Schroder Adveq, 2018

In order to fund such steep purchase prices, large buyout funds have used high levels of debt, making these acquisitions more risky than small buyouts from a leverage perspective.

Small buyouts with lower leverage

Debt/EBITDA multiples US small and large buyouts

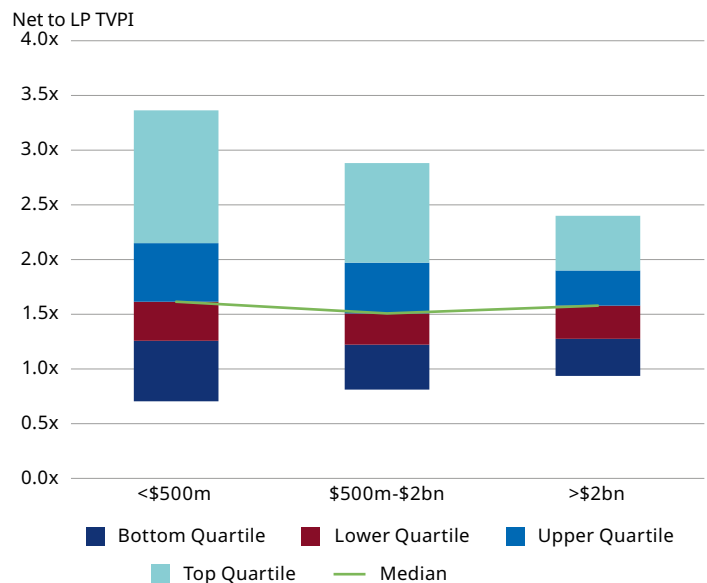


Source: Baird, S&P 2017, Schroder Adveq, 2018

Successful small buyout managers have historically capitalised on these inefficiencies and, as a result, have delivered the highest absolute returns in the market. Interestingly, many large buyout firms have even launched small buyout sub-strategies in order to re-capture the glory days of high returns, providing additional confirmation on the high return potential of the strategy.

Small buyout managers have the potential to meaningfully outperform their larger peers

Manager selection is key when investing in small buyouts



Data as of 31 March 2018; includes buyout funds between 1986-2014. Pooled returns are net of fees, expenses and carried interest. Data excludes top and bottom 5% of funds. Source: Cambridge Associates, Schroder Adveq, 2018

However, as the data indicates, manager selection is a key consideration as dispersion of outcomes can be wider in small buyouts.

Example of value creation in small buyouts:

Company A was a family-owned trucking and logistics company. The company had a leading market share in its local region and wanted to expand geographically in order to scale its relationships with its retail customer base yet lacked the capital and know-how to execute this strategy. The owner was looking for a capable buyer that would allow him to step back from running the day-to-day operations as he was nearing retirement age and had no heir to pass the business on to. Over the next six months and multiple meetings, General Partner X ("GP X") was able to demonstrate its sector expertise and introduced the owner to its prior management team that successfully transformed a similar business with great results. Mutual trust was built up and the two parties agreed on a fair sale price at 6.0x EBITDA. Post-close, GP X brought in its veteran management team including a CEO, CFO and a vice president of operations which identified a target list of attractive add-on candidates and ultimately closed five accretive tuck-in acquisitions at an average of 4.0x EBITDA. After successfully integrating the add-ons and tripling the size of the company over the course of three years, the GP was able to sell the company to a larger buyout fund for 10x EBITDA, generating a substantial return to investors and providing a roadmap to the larger buyer of how to successfully continue to grow through acquisition.

How to systematically generate returns from inefficiencies

Given its outperformance potential, Schroder Adveq believes that US small buyouts can provide a compelling complement to an investor's large buyout exposure. However, many investors, despite wanting to access the small buyout market, face structural issues preventing them from doing so. Some common constraints include:

- The average investment size that institutional investors want to deploy is too large for a small fund (in the case of a primary investment) or for a small company (in the case of a direct/co-investment)
- The diligence and effort required to find, select and commit to multiple small funds is high compared to the investment volume deployed
- There is generally a lack of team resources to cover a large market including all of its sub-regions combined with limited travel budgets to form adequate market coverage

These obstacles can limit a single investor's ability to participate in the largest part of the US buyout market (in terms of number of managers) and the prospect of covering 1,000 small buyout managers is indeed daunting. However, it is a misconception that this segment of the market is therefore out of reach. Even novice investors can access the top small buyout funds so long as they invest through the right partner. By piggy-backing on a specialised limited partner's credentials through an investment in a fund of funds, co-investment fund or separately managed account, it is possible to get the desired small buyout exposure. A specialised provider will have a replicable playbook for covering the landscape and identifying attractive managers to back and have access to the best funds and transactions.

Good market coverage requires rigorous organisation, active networking and the use of technology and databases to be effective, and a dedicated partner will already have these capabilities in-house.

Portfolio construction

In order to generate the highest risk-adjusted returns from small buyout investments, it is critical to build a portfolio that is well-diversified. While industry diversification is a more obvious portfolio construction technique, it is important to also diversify by lifecycle of firms and by transaction type.

Lifecycle of firms

An advisable approach to firm lifecycle diversification is to combine repeat top performers with high potential emerging managers³. Repeat top performers that are adhering to the strategies that made them successful in the past can help reduce variability of outcomes in a portfolio and still deliver excellent returns. A key requirement for a successful small buyout investment programme is the ability to gain access to such managers who are often in high demand and have their pick of limited partners. To obtain this access, it is important to consistently build relationships over multiple years as these managers want to see a dedicated commitment to their firms as well as the small buyout space in general.

Importantly, strong past performance is not a guarantee of future success and oftentimes, yesterday's top performing small fund wants to raise a much larger fund, possibly abandoning the compelling dynamics of the inefficient market. To build a sustainable small buyout programme, it is important to continuously look for tomorrow's leading small buyout firms and to selectively back emerging managers. This is no easy task, and best practice, as it relates to sourcing emerging managers, entails attending conferences, chasing down leads with new firms and canvassing the market for spin-out groups. The best emerging managers combine the skill of seasoned investors and operators with the strong alignment of interest that comes with building an early track record. In this stage of firm lifecycle, carried interest and the survival of a manager's firm can be a strong motivator and is a key reason emerging managers have the potential to deliver outperformance.

Investment type

While primary fund commitments can generate excellent investment results, these results often take time to develop and it can be several years before a pure primary fund portfolio shows its true potential. In order to accelerate performance and limit J-curve⁴ effects of primary fund investing, a blend of transactional investments such as direct co-investments and secondaries is advisable. Successful direct co-investments allow an investor to put capital to work directly into a company alongside a manager and, assuming rapid value creation, can provide earlier uplift in value and a faster exit than a fund investment, often without having to pay management fees and/or carry. Secondary transactions essentially skip

3 Emerging managers are defined by Schroder Adveq as institutional funds I, II, or III as well as independent sponsors and deal-by-deal groups

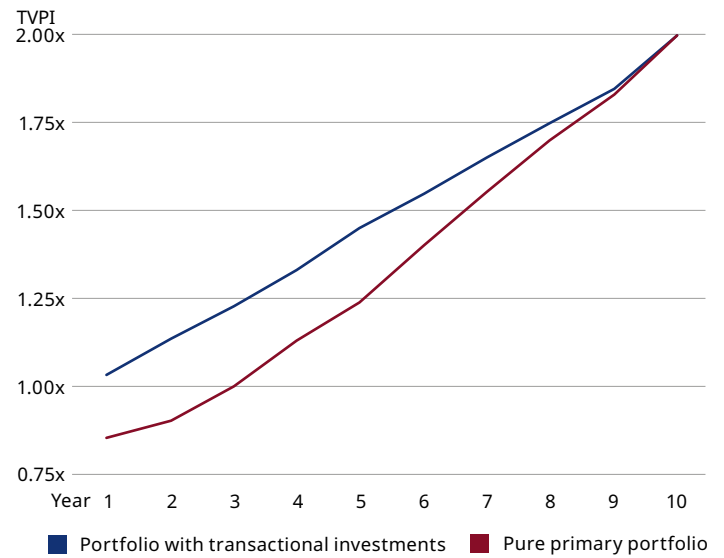
4 A phenomenon whereby a period of early unfavourable returns due to fees is followed by a period of rising returns such that the end-point surpasses the starting point to form the shape of a J

the longer investment period of a fund and allow a buyer to evaluate the quality and progress of a portfolio and often buy these positions at a discount which provides immediate uplift upon entry. Furthermore, many of the companies in a secondary transaction have already experienced their value creation phase and are ready for monetisation, allowing for more rapid liquidity to investors.

Smaller funds frequently offer these direct co-investment and secondary opportunities to limited partners who possess the capability to transact. For co-investments, this situation arises because smaller funds need additional equity to complete a deal due to their smaller fund sizes. For secondaries, smaller and more exclusive funds want to control the composition of their investor base and prefer limited partners who are committed to their segment of the market and can be investors in future funds. Small buyouts provide fertile ground for transactional investments and are highly conducive to performance-oriented portfolio construction.

Hypothetical J-Curve illustration

Hypothetical return trends with and without transactional investments



Source: Schroder Adveq, 2018

Conclusion / Summary

US small buyouts exploit many market inefficiencies that can translate into exciting investor returns. These inefficiencies are structural and enable skilled small buyout managers to buy companies for attractive valuations and enact replicable value creation strategies. A host of well-funded and acquisition-hungry buyers at the efficient larger end of the market provide robust exit opportunities that reward successful business transformations with multiple expansion and strong risk-adjusted returns. Despite this attractive dynamic, many investors forego small buyout investments due to their inability to cover such a sizeable market efficiently and miss out on ~90% of the fund managers in the US buyout segment. Schroder Adveq recommends increasing exposure to small buyouts by partnering with a provider that specialises in this segment, one who can secure access to repeat top performers and high-potential emerging managers in their funds, and invest directly alongside such managers through co-investments into their company transactions. This approach can deliver outsized returns throughout the lifecycle of a small buyout portfolio.

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