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'Same as it Ever Was': The Enduring Case for Small-Market Private Equity

by Matt Petronzio, Twin Bridge Capital Partners

Twin Bridge Capital Partners is a Chicago-based private equity firm with deep experience investing in the North American small and lower middle-market buyout industries. We are an active and accomplished buyout fund and equity co-investor and have deployed more than $1.9 billion since our founding.

Matt Petronzio, Partner, has extensive experience in the middle-market buyout industry, with particular emphasis on the small market buyout space. He shares responsibility for all aspects of the Firm's investment, portfolio management and fundraising activities. Mr Petronzio serves on the Twin Bridge Investment Committee.

SAME AS IT EVER WAS…

In an increasingly complex investment world, the North American small-market buy-out (SMB[1]) market is really the same as it has always been, or the 'same as it ever was' in the immortal words of the Talking Heads' David Byrne.[2] In fact, historical industry returns illustrate that the SMB market has been a segment of private equity that offers outsized returns due to its simple, yet enduring characteristics, which have been fundamental to private equity since its earliest days. The potential benefits of investing in SMBs are clear, and institutional investors continue to seek meaningful allocations to this part of the market.

At its essence, investing in SMBs typically offers a refreshingly simple value proposition for institutional investors, namely its ability to offer the following:

- A sizeable target market with extensive investment opportunities;
- Prolific opportunities for partnership with high quality teams;
- Abundant opportunities for creating fundamental financial improvement; and
- Attractive exit avenues to financial and strategic buyers eager to acquire larger, more profitable, and better-run organisations.

It sounds like 'mom and apple pie' for private equity investors, right? Not so fast.

As in all segments of private equity, manager selection is key. Differentiated approaches to sourcing, business building, and corresponding value creation are paramount. An investor's ability to effectively identify these differentiating skills and attributes can provide

consistently better results. When institutional investors apply best-in-class value creation strategies to small, entrepreneurially owned and operated businesses, the impact can be profound. Same as it ever was, to be successful in the SMB market, one must consistently and accurately track the market participants and back the very best managers in each vintage year.

ONLY THE NAMES HAVE CHANGED…

'It's all the same. Only the names have changed,' observed Jon Bon Jovi.[3] Could he have been talking about small-market buy-outs? In the SMB market, it seems that past is prologue. It could be great material for a new song:

- New manager struggles to raise first fund
- Manager generates solid returns
- Manager gains trust and increased investor support
- Manager doubles fund and moves up-market
- Manager loses edge and returns revert to the mean
- Chorus…
- New team leaves old manager and struggles to raise first fund…

Thankfully, this cycle of creation and destruction brings a fresh crop of new teams every year and affords investors new opportunities to partner with hungry, experienced professionals.

Historically strong returns and robust deal flow within the SMB market have typically made it an attractive private equity segment in which to invest. In fact, since the beginning of the decade, deals with an enterprise value below $100 million have made up 68.8% of all private equity deals in the US.[4]

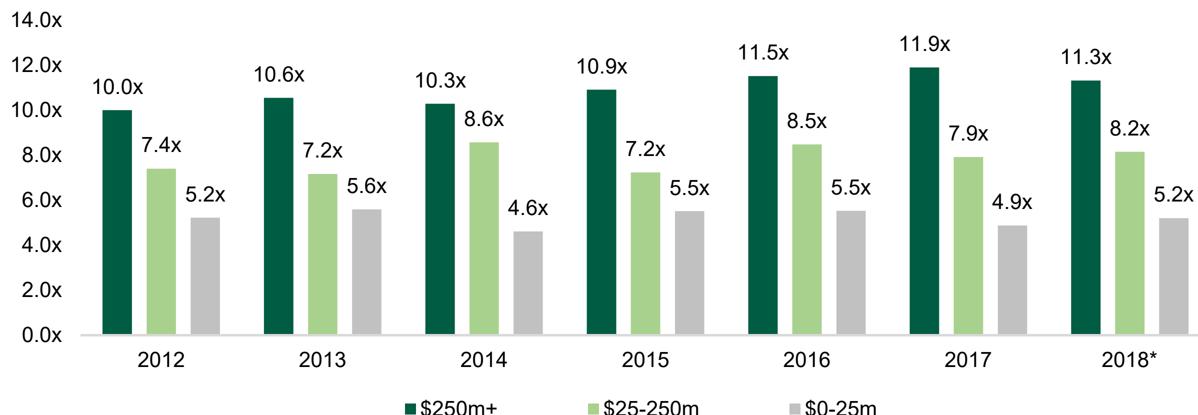
The SMB market is generally comprised of companies that are considerably lesser known and less established, thereby presenting the potential for market and valuation inefficiencies that investors can potentially translate into accretive returns for their portfolios. SMB companies are generally sold in less efficient markets at valuations below those of larger buy-out deals and public comparables. Because sponsors can typically acquire SMB companies at relatively lower valuations, they may be able to employ more conservative capital structures. Myriad routes to value creation exist in the lower middle market, including organic revenue growth, operational enhancements, add-on acquisitions, managerial improvements, and multiple expansion. For example, many lower middle-market companies are quality businesses, but with often underdeveloped information technology and management information systems. These risk–reward dynamics have historically contributed to strong returns in the SMB market over the long term.

The particular attributes that make the SMB market most compelling are as follows.

Abundant number of target partner companies — The majority of businesses in the United States are small. According to data from the Census Bureau's Annual Survey of Entrepreneurs, there were 5.6 million employer firms in the United States in 2016. Firms with fewer than 500 workers accounted for 99.7% of those businesses. The United States' small businesses employed 58.9 million people, or 47.5% of the private workforce, in 2015.[5] Businesses with strong revenue growth and profitable cash flow profiles are prime candidates for private equity sponsors in the SMB space.

Lower average purchase prices and more conservative capital structures — Small companies are inherently more fragile and exhibit risks that larger, more stable businesses do not. This provides an excellent opportunity for institutional investors to acquire businesses at lower average purchase price multiples (as illustrated in Figure 1) and to utilise lower average financial leverage to consummate their investment. The muted benefits of leverage in the small-market space are typically offset by above-market growth rates of these small businesses.

Figure 1: Global private equity deal multiples by enterprise value

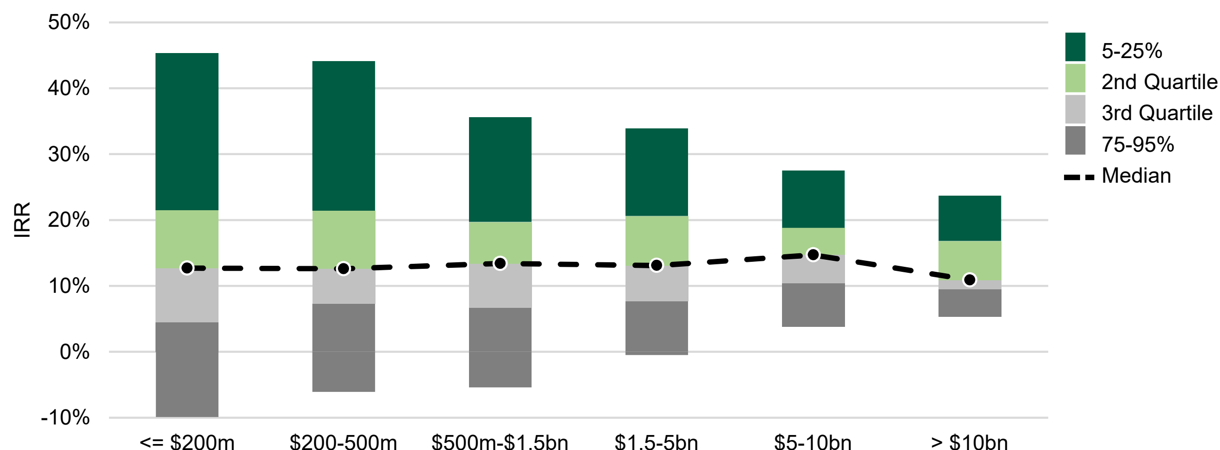


*Source: PitchBook, 2018 Annual Global PE Deal Multiples; ranges in legend represent deal enterprise values. *2018 figures as of 15 November 2018.*

Considerable business professionalisation and enhancement opportunities — Family-owned and entrepreneur-owned small businesses are typically undermanaged and under-capitalised relative to their larger peers. This can stifle the opportunity for growth. Private equity teams can professionalise management and quickly identify necessary changes in the senior staff, refine purchasing and supply chain systems, optimise working capital, and redeploy assets to their best use. This often provides for increased operating leverage, which may enhance profit margins and cash flow.

Superior return opportunity versus larger funds — Private equity sponsors in the SMB market generally seek to generate a 3.0x gross multiple of invested capital and 25% gross IRR over a five-year period for each discrete portfolio investment. This typically translates into net returns for successful managers exceeding 2.0x aggregate invested capital, which is attractive and consistent with past performance. A derivative of this investment-level performance is reflected in the benchmark returns. According to data from Cambridge Associates, the SMB segment of US private equity has consistently generated the best returns, as illustrated in Figure 2.

Figure 2: US private equity quartile performance by fund size



Source: Cambridge Associates LLC Private Investment Database as of 31 March 2019.
Note: Private equity includes buy-outs and growth equity. Pooled returns are net of fees, expenses and carried interest. Includes vintage years 1986–2016. Vintages after 2016 are considered too young to have meaningful returns.

For investors with appetite for SMBs, the segment offers a compelling risk–return opportunity, which is enhanced significantly by investment in top-quartile performers in the space.

Fewer dollars raised to tackle the SMB market — The preponderance of private equity capital raised is allocated to large and mega private equity funds. Yet this capital is dedicated to acquiring the smallest universe of potential companies. We would argue that there are fewer operational value creation opportunities available to these larger businesses, and a greater reliance is placed on financial engineering to generate returns when compared to the SMB market.

The advantage of focused strategies — Single-sector strategies can be advantageous both in terms of value creation opportunity and returns in the SMB market. This is evidenced by Cambridge Associates' research in this area.[6] Private equity managers that target specific industries such as the consumer sector, financial services, healthcare, or technology tend to outperform their generalist peers in the same space.

Next-generation managers matter — Some of the very best opportunities for investment in the SMB market come from next-generation managers. However, manager selection remains paramount as there are certain attributes that the most successful firms have in common. Teams of experienced private equity investors who have worked together in the past and have attributable track records of success generally provide a good starting point. These teams often endeavour to execute a strategy consistent with what they have always done (often at larger, better-known firms), but within the context of a smaller fund. It is imperative that they exhibit humility and an understanding of how difficult it is to generate consistently exceptional results. They need to have achieved great individual success, but also to have made mistakes and learned from them. Partners at next-generation firms have decided to become entrepreneurs in their own right and thus need to invest as much money in their new business as possible, until, in the timeless words of John Cougar Mellencamp, it 'hurts so good'.[7] These teams in transition, who have so much at stake (in terms of both capital and reputation), are particularly compelling.

Limited partner alignment — SMB managers are often better aligned with their limited partners since they derive the majority of their income from carried interest on investment performance rather than management fees. A smaller fee base does not allow for the same current income, and the urgency of outperformance is acute. After all, investors and fund managers should be perfectly aligned from a multiple-of-money perspective. Higher fee models may also dull the edge essential for meaningful outperformance.

Superior co-investment opportunities for capable investors — Smaller buy-out funds, especially next-generation managers accustomed to writing larger checks, utilise co-investment meaningfully to 'punch above their weight'. This dynamic allows well-equipped and nimble co-investors to achieve no-fee, no-carry co-investments which may enhance the overall economic equation and return profile of the investment.

GETTING WHAT YOU WANT (AND NEED)...

'You can't always get what you want, but if you try sometimes, well, you might find you get what you need.'[8] The Rolling Stones must have been thinking about accessing the highest-quality small-market managers in buy-out. Thanks, Mick. It is truly difficult to consistently find, and invest with, the best managers in the SMB market, so if an investor wants exposure here, that investor needs to be prepared.

Difficulty of accessing high-quality SMB managers — Similar to accessing the highest-quality venture capital managers, scarcity is a real factor when it comes to investing with SMB managers. The highest-quality SMB managers — those with differentiated track records of success and compelling value propositions — tend to raise capital very quickly and generally do not accept many new investors, if any at all.

Potential commitment sizing difficulty for larger investors — Due to the smaller targeted fund raises in the SMB market and the scarcity that the highest-

quality managers boast, it is difficult for larger investors to achieve scale in the most desirable funds. Knowledge of the market and the ability to move both quickly and with conviction are crucial to successfully acquiring desired allocations.

Smaller teams with less robust infrastructure — The SMB market, and in particular, next-generation managers, often have smaller, less built-out teams that lack the robust staffing models of larger peers. More often than not, the team is in development and is somewhat constrained by the fees that these models are able to generate. Deal teams are smaller and fewer operational and back-office resources are present at the outset. Underwriting rigour, operational due diligence expertise, and an ability to 'see around corners' to a firm's future capabilities are essential to effective investing in this part of the market.

Increased risk associated with SMB investing? — This is a definite 'maybe'; the answer is not as straightforward as it may seem. Judgement and pattern recognition are imperative when considering investments in the SMB market. Smaller enterprises may be more susceptible to macro-economic swings and recessionary periods than their larger peers, but they also perform better during times of economic recovery. Cycle-tested private equity sponsors with lower loss rates (both in terms of number of platforms and capital) typically generate the best performance. These teams are able to capitalise on the asymmetric upside from small company growth, while at the same time minimising downside risk. Most often they invest in business models with recurring revenue, strong profit margins and favourable working capital dynamics. Conservative financial leverage and greater equity as a percentage of overall capitalisation further mitigate risks that are outside the control of the private equity sponsor. Here again, manager selection and underwriting matter most.

CHOOSING TO DECIDE…

'If you choose not to decide, you still have made a choice.'[9] Even Geddy Lee and his Rush bandmates knew that not acting is an act in and of itself. Investors need to be committed participants in order to have success in small company private equity investing. When evaluating SMB opportunities, there are a few additional matters to consider.

Brand value and 'proprietary' sourcing potential — When evaluating SMB managers and next-generation teams specifically, it is critical to understand how they intend to differentiate themselves in the market from a sourcing perspective. The loss of the 'halo effect' from a larger, branded and well-known firm can adversely impact their ability to see the same deal flow and win great opportunities. SMB managers that convincingly articulate thematic sourcing strategies and developed processes for uncovering unique opportunities are particularly compelling given the competition for attractive assets. (PS — There is no such thing as 'proprietary' deal flow, despite what fund managers say.)

Increasing competition for co-investment — SMB managers have, on average, a greater need for co-investment due to the smaller size of their capital base and their desire to 'punch above their weight'. However, the number of co-investors desirous of fee- and carry-free co-investment and the competition for these opportunities are increasing each year. Dedicated resources and a track record of executing co-investments quickly and efficiently is critical in messaging to SMB teams.

Increased role of independent sponsors — There has been a proliferation of new firms in the independent sponsor market. Thanks to the relative ease of capital raising for single direct transactions, many new firms have been created in competition with more traditional private equity firms. Principally formed by investment bankers, consultants, and corporate executives, these companies are creating deal-by-deal or limited pool strategies to compete with private equity firms. The end goal is usually to build a referenceable track record in order to raise a traditional pool of capital in the future. Some of these teams will ultimately succeed but, generally speaking, stable capital and resources are imperative when it comes to building an institutional-quality team. We prefer to let these teams incubate.

We track them over time to identify the 'winners' in the hopes of backing the highest-quality firms as they develop into traditional private equity players.

THE SONG REMAINS THE SAME…

I think Led Zeppelin had it right when they said: 'The song remains the same.'[10] Great musicians and experienced private equity investors know a good thing when they see it. Nothing has fundamentally changed in this part of the market, and it is truly the 'same as it ever was'. Despite the professionalisation of the industry, the multitude of strategies and approaches to buying private businesses, and the sheer number of firms participating in the investible universe, the key attraction and merits of investing in the SMB market remain the same. The large and prolific pool of target investments, the numerous ways to create value in undermanaged businesses, the asymmetry between capital raised and opportunities available, and the unique expertise to exploit these attractive attributes together help SMB investors to generate market-leading returns.

1. *Defined by Twin Bridge Capital Partners as funds targeting aggregate commitments of $400 million or less.*
2. *Talking Heads, Remain in Light, Sire Records, 1980.*
3. *Bon Jovi, Slippery When Wet, Mercury Records, 1986.*
4. *PitchBook, 2018 Annual US PE Breakdown.*
5. *SUSB Statistics of US Businesses, US Census Bureau, 2015.*
6. *Cambridge Associates, Declaring a Major: Sector-Focused Private Investment Funds, September 2014.*
7. *John Cougar Mellencamp, American Fool, Riva Records, 1982.*
8. *The Rolling Stones, Let It Bleed, Decca Records, 1969.*
9. *Rush, Permanent Waves, Anthem Records, 1980.*
10. *Led Zeppelin, The Song Remains the Same, Swan Song Records, 1976.*