STEPSTONE

Pound the table for small buyouts

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Introduction

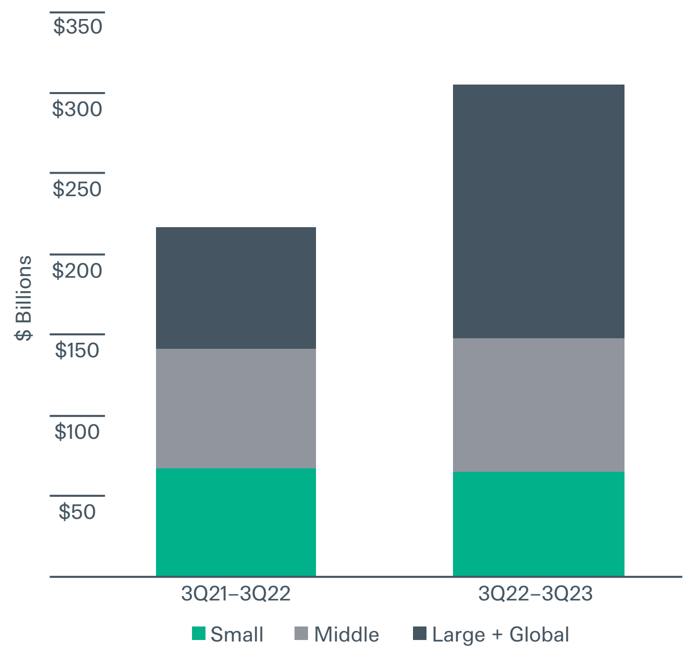
When we wrote our last paper on small-market buyouts (SBOs), we wanted to remind investors why they should not neglect small-cap managers in the current environment. Hence the title "Fight the urge (to cut back on small buyouts)."

Our thesis was straightforward: Market uncertainty would lead investors to overweight large-cap managers at the expense of their smaller counterparts and, in doing so, forgo an attractive diversification opportunity while injecting a fair amount of beta into their portfolios.[1] Owing to people's propensity to flock to the familiar when the future looks grim, the outcome wasn't surprising. SBO fundraising fell by 5%, and the amount raised by large and global caps grew 106% (**Figure 1**). In total, SBOs' share of the fundraising pie is nearly a third lower than it was in the previous period.[2]

During the intervening 12 months, the macro picture hasn't changed all that much. Inflation, interest rates, geopolitics and lending conditions remain top of mind. Add to that dueling numerator and denominator effects and a marked decline in distributions, and it becomes clear there are a lot of factors weighing on investors.[3]

We believe these added complexities make SBOs even more enticing. To be clear, the sector's conservative use of leverage, focus on operational value-add, and relative insensitivity to public market fluctuations—all of which we covered in our 2023 report—still hold water. So in this paper we focus on small buyouts' recent resilience—specifically their ability to provide liquidity—and the underlying traits that make its resiliency possible: outsize return potential, consistent net cash flows, more stable valuations, and access to credit markets.

FIGURE 1: BUYOUT FUNDRAISING BY PERIOD



Source: SPI by StepStone, October 2023.

Though not a cure-all for LPs' portfolio woes, for a number of reasons, SBOs can help. Their potential to consistently generate alpha and distributions should be a welcome reprieve for LPs today and is ample reason in our opinion to keep pounding the table for SBOs.

[1] They'd also risk unwinding much of the progress made toward increasing the number of diverse managers.
[2] We define small-market funds as those raising less $2 billion; middle-market funds as $2B–7B; large-market funds as $7B–12B; and global funds as greater than $12B. Unless otherwise noted, this definition applies throughout the paper, save for Figure 10, which includes some older data that follows our older classification.
[3] The numerator effect explains how changes in private market valuations (the numerator) can lead a portfolio to be over/under-allocated to private markets; the denominator effect explains how changes in public market valuations (the denominator) can lead a portfolio to be over/under-allocated to private markets.

Capital overhang

The rate and scale at which GPs are returning to market have exacerbated the denominator effect. Large- and global-cap GPs have driven much of the dry powder growth. SBOs' growth, by comparison, has been muted. Despite having a larger universe of companies to invest in, the sector's AUM has grown at a modest CAGR of 5% over the past 10 years—roughly a third the rate at which large and global caps have accumulated capital (**Figure 2**).

Well positioned for liquidity

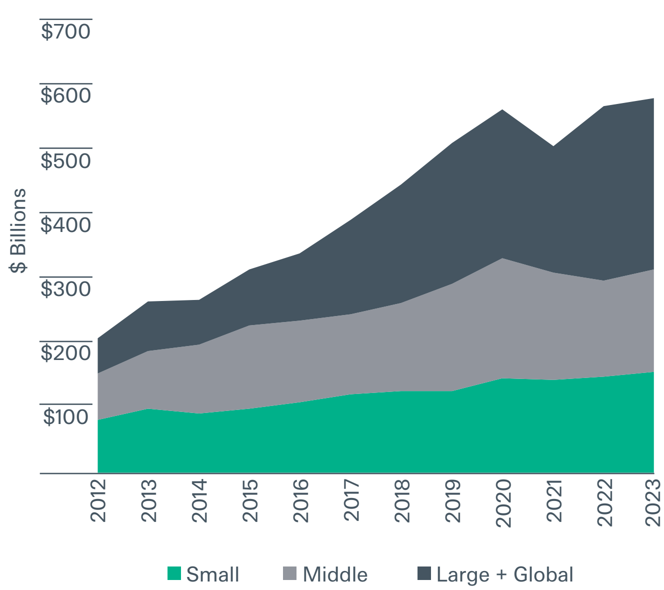
Because they are sitting on a quarter-trillion dollars of dry powder, these larger managers are highly incentivized to deploy capital so they can raise new, fee-generating funds. M&A and middle-market loan volumes have been in a gully, and companies owned by SBO sponsors are a logical destination for that mountain of capital.

Owing to a more stable interest rate outlook, a more positive outlook for M&A, and the healthy amount of dry powder, investment activity is likely to pick up in 2024, so we'd expect a lot of SBO managers to sell to larger financial and strategic buyers.

Recent exits

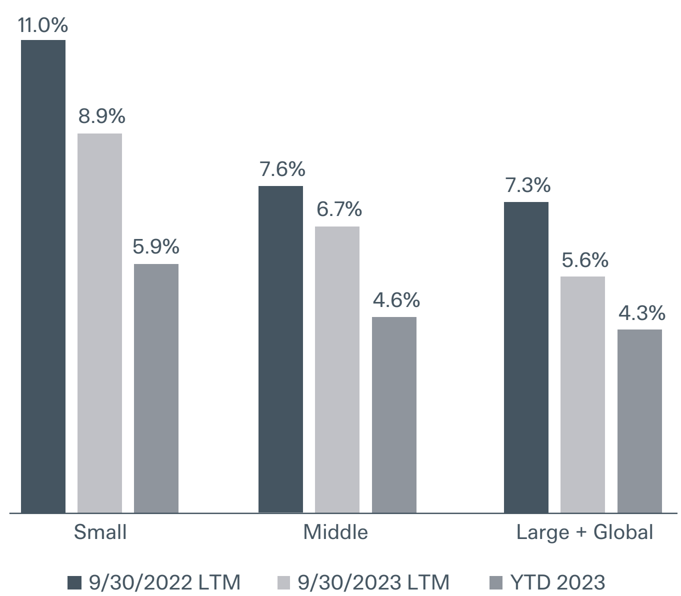
Some evidence of this has started to emerge. SBO funds have sold 5.9% of their investments through the first three quarters of 2023 and nearly 9% in the LTM ended 3Q23 (**Figure 3**). These results, which are consistent with our broader observation that SBO funds have historically generated higher levels of exit activity, should be well received by investors clamoring for realizations and distributions.

FIGURE 2: BUYOUT DRY POWDER GROWTH BY TRANCHE



Source: Preqin, April 2024.

FIGURE 3: BUYOUT EXIT ACTIVITY (3Q21–3Q23)

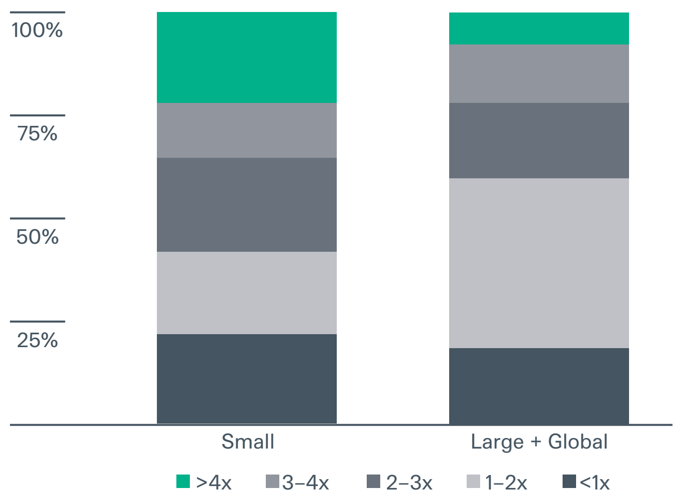


Source: SPI by StepStone, September 2023.
Note: Reflects percent of deal count (exits/total).

Performance

The performance of recent exits has also been strong. In aggregate, realized small-buyout deals have generated a gross TVM of 3.0x. Digging deeper into the data reveals more than a third of deals realized since 3Q21 have delivered 3x or higher (**Figure 4**). SBOs' "home run potential" appears to be very much intact. SBOs' return dispersion is greater, but LPs have been compensated for bearing this risk.

FIGURE 4: TVM DISTRIBUTION OF REALIZED DEALS BY DEAL COUNT (3Q21–3Q23)



Source: SPI by StepStone, September 2023.
Note: Reflects percent of deals by count.

Cash flow activity

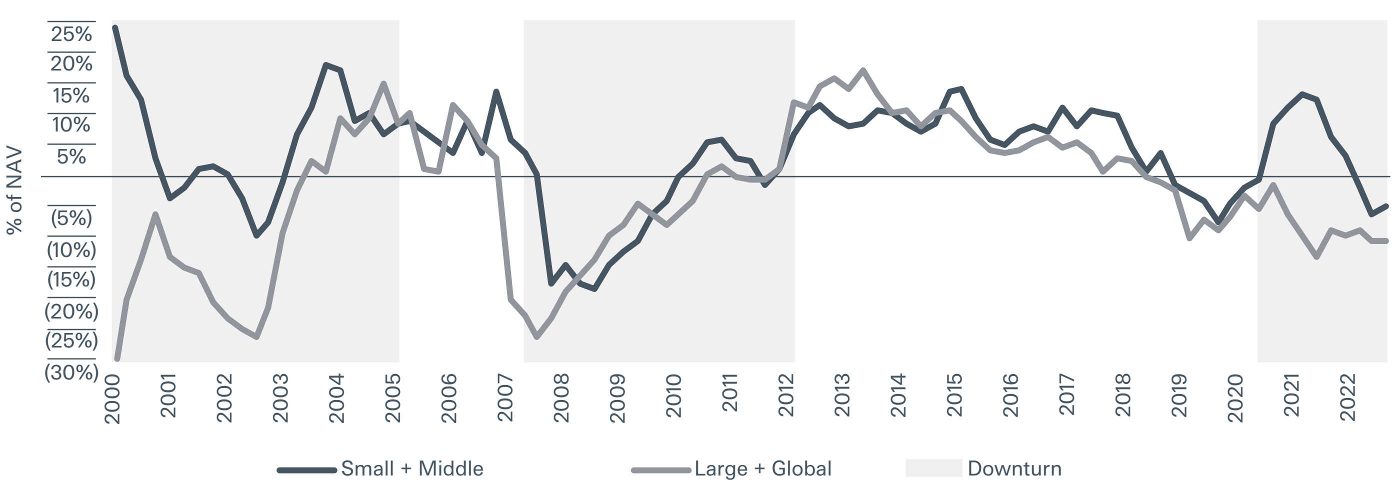
A greater percentage of exits coupled with strong realized performance has amounted to better cash flow. As seen in **Figure 5**, market volatility tends to have less of an effect on SBOs' net cash flows, and this trend has continued into the current market cycle. There are a couple of dynamics at play.

1. Contributions—On a relative basis, SBO funds tend to be more consistent about putting capital to work across vintages. Contributions to SBO funds are 17 percentage points higher than the long-term average of equivalently aged larger funds.
2. Distributions—Across time, distributions from SBOs have been 7 percentage points higher—again, compared with the long-run average for large buyouts.

The net result: Average SBO net cash flows tend to be higher and more stable. In the next section, we'll address how valuations have also been more stable.

So far, the view we've explored has been sanguine. But if things don't pan out the way many expect them to, and economic conditions deteriorate, are SBOs still a good play? Spoiler alert: We think so.

FIGURE 5: BUYOUTS' 4-QUARTER NET CASH FLOW (% OF NAV)



Source: SPI by StepStone, September 2023.
Note: Includes 344 large and global buyout funds and 747 small and middle buyout funds, with vintages from 1988 to 2022.

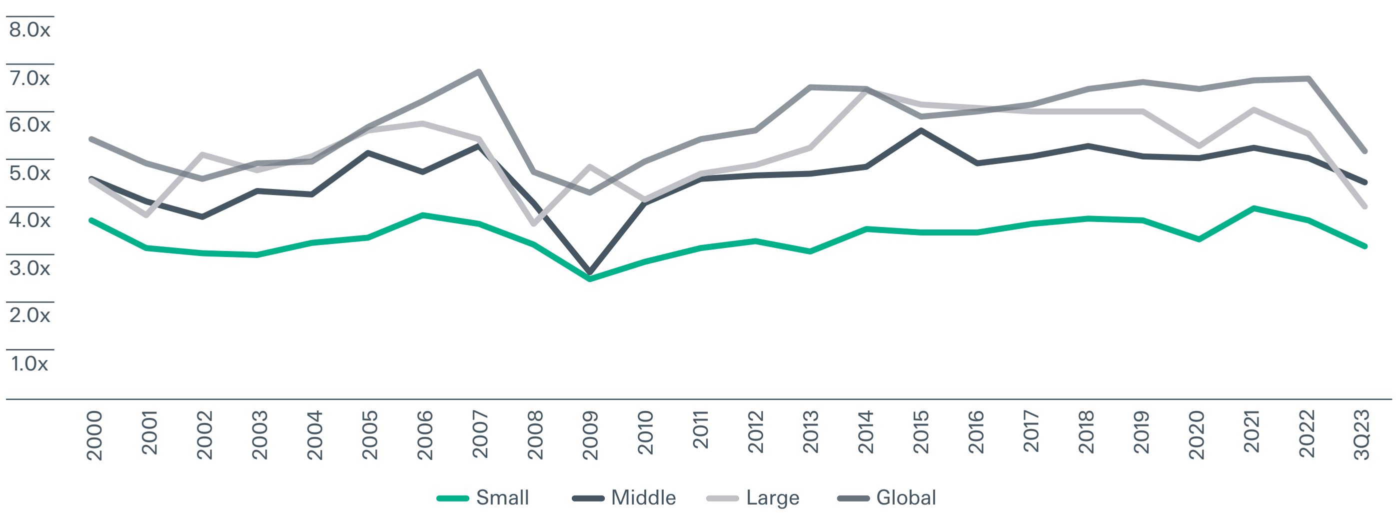
Less sensitivity to interest rates

Starting in March 2022, central banks around the world raised policy rates to their highest levels in more than 15 years, creating challenges for capital-intensive industries—including some buyout firms.[4] Elevated interest rates have been less of a problem for small-buyout shops because they tend to be less reliant on leverage to generate attractive returns (**Figure 6**). So even if central banks opt to buck expectations and keep rates elevated, SBO managers should be able to cope.

Lending conditions

Consolidation in the banking sector coupled with the failure of small regional banks has led some observers to express concerns about small companies' ability to access debt markets. And while it's true that the number of regional banks that have traditionally served the lower end of the market has fallen steadily over the past 20-plus years, the persistent growth of direct lenders (read: private debt) has filled the void. These direct lenders cater to the small and medium-size

FIGURE 6: MEDIAN LEVERAGE MULTIPLES FOR NORTH AMERICAN BUYOUTS



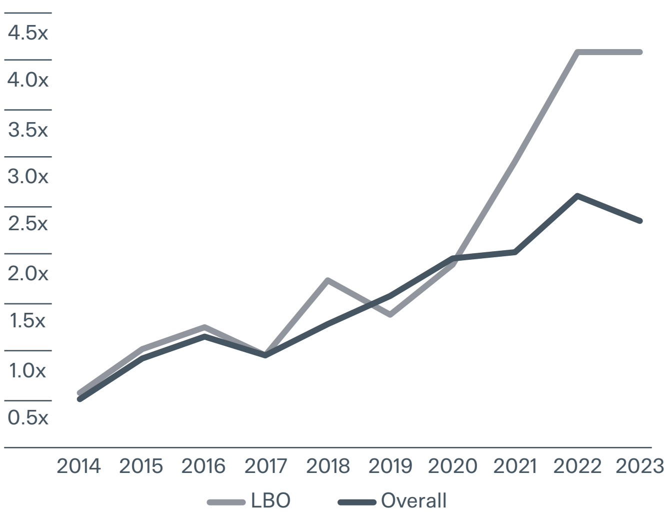
Source: SPI by StepStone, September 30, 2023.
Note: Includes 5,918 small-market buyouts (TEV <$250M), 1,877 middle-market buyouts (TEV $250M–600M), 911 large-market buyouts (TEV $600M–1,000M), and 1,847 global-market buyouts (TEV >$1,000M) made in North American companies between 2000 and 2023. StepStone acquires proprietary operating metrics through investment due diligence and portfolio monitoring.

[4] The Federal Funds Rate hasn't eclipsed its current level of 5.3% since 2001; rates in the EU haven't reached 4.75% since 2008.

companies as well as private equity sponsors that operate within this segment.

Figure 7 shows how direct lending's share of the middle market has grown over time.[5] For every loan underwritten by syndicated lenders in 2023, direct lenders underwrote more than two, and their share of the leveraged buyout (LBO) market is even more lopsided. Interestingly, the rise in direct lending's market share coincides with the high-interest-rate environment. For borrowers, this higher prominence of direct lending has been a good thing.

FIGURE 7: MIDDLE MARKET LOAN VOLUMES (DIRECT LENDING/SYNDICATED)



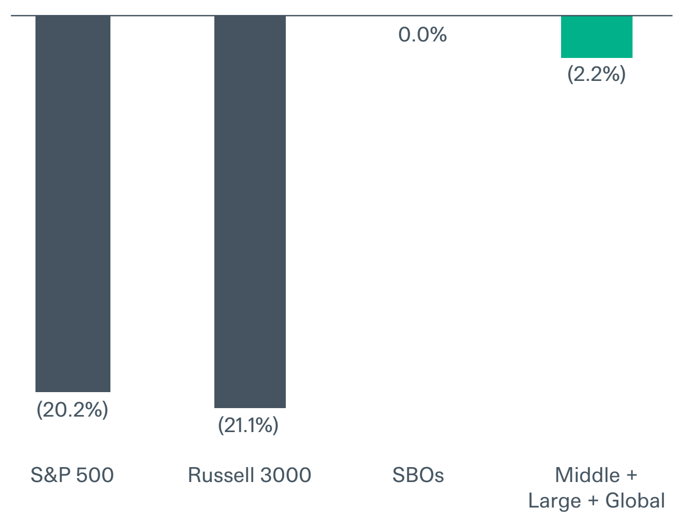
Source: LSEG LPC, January 2024.

Partnership and flexibility are two of the hallmarks of the direct lending model. These firms work closely with borrowers (and their private equity backers) to closely monitor the borrowers' financial health. If borrowers are facing solvency issues, direct lenders intervene—bringing to bear the weight and experience of internal "workout" teams that help borrowers right the course. A large syndicate of lenders, by contrast, may be tempted to just write off such loans as a loss. This partly explains why direct lending has historically had low loss rates. That many of these borrowers fall within what we call the "small market" adds further credence to the notion these smaller borrowers aren't as risky as many presume.

Greater stability and faster recovery times

In our 2023 paper on SBOs, we demonstrated that on average, for every dollar the stock market loses in value, SBO fund valuations fall by just 70 cents. So far, the current cycle is delivering more of the same, with all tranches of the buyout market delivering superior asymmetric risk capture (**Figure 8**).

FIGURE 8: DOWNMARKET CAPTURE 1Q22–2Q23

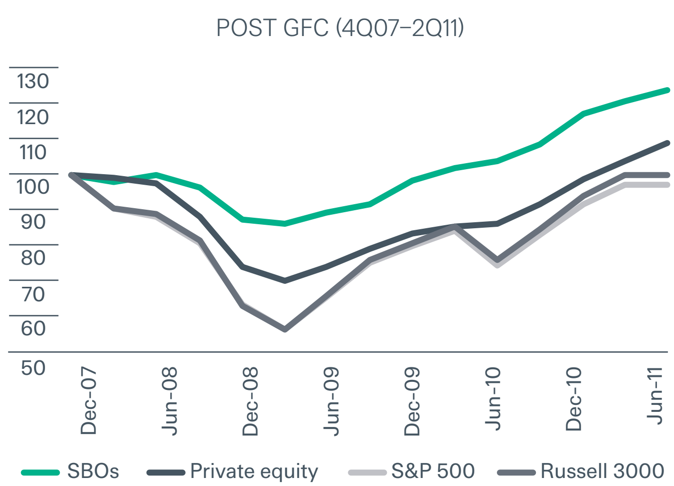


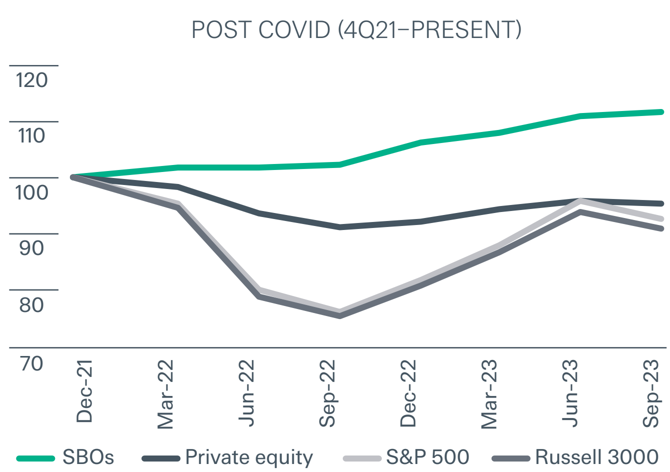
Sources: Capital IQ, Burgiss Private iQ and StepStone, January 2024.

[5] Here, mid-market refers to companies whose EBITDA is $5M–75M. What we call the small market resides at the lower end of this spectrum (i.e., $5M–50M).

Because private equity valuations have been less volatile than those of public equities, once the recovery is underway, private equity as a whole has less ground to make up, generating superior returns over the medium to long run with SBOs leading the way. Evident in the current cycle, this performance trait has persisted through multiple economic cycles (**Figure 9**).

FIGURE 9: CUMULATIVE BUYOUT RETURNS: POST GFC AND POST COVID





Source: SPI by StepStone, March 2024.
Note: Private equity figures includes SBOs. Post-GFC period includes 1,254 private equity funds; Post-Covid period includes 2,624 funds.

Pricing discipline and uplift

As noted in our previous paper, there are several reasons SBO funds are less sensitive to fluctuations in the equity markets. Here we're homing in on "uplift at exit." Small cap managers are typically more conservative in marking up valuations before an exit.[6] So, when the time to exit comes, there is more headroom for growth. **Figure 10**, which draws from our proprietary data platform, shows that five quarters before exit, valuations between tranches are comparable. While all three tranches show uplift, SBOs' are a mite higher than that of the middle market.

FIGURE 10: BUYOUT UPLIFT AT EXIT ANALYSIS BY TRANCHE

Source: SPI by StepStone, March 2024.

In the broader context of market volatility this means investors can have greater confidence in their portfolio's unrealized SBO valuations, which further reinforces our point about SBOs' relative insensitivity to public markets and their ability to generate strong cash flows.

[6] There are several reasons for this. One is that small-market companies have fewer public comps. Another is that SBO fund managers tend to be more reliant on carry than on management fees. So in general, we'd posit that SBO managers care more about exits than interim marks.

Conclusion

We closed our previous report by saying there's no better time than now to increase your allocation to SBOs. Turns out, we were right. However, we were too narrow in our scope. The research in this paper demonstrates that the factors at play within small buyouts during the prevailing twelve months also transcend market cycles. Through our coverage of the buyout market we have found SBOs can be an important diversifier that allows investors to tap into return drivers and upside potential not available upmarket. While the return dispersion is widest among buyout strategies, our last paper concluded diversified portfolios are well compensated for the risk. Investors can further mitigate downside by working closely with a partner that has the resources necessary to navigate this large and fragmented segment of the market.

By focusing on SBOs' ability to generate liquidity and the reasons for that, we hoped to explore another facet of SBOs —one of acute interest to investors today. In short, SBOs have generated more exits than other buyout strategies over the past two years, and during that period, the exits have generated some very attractive returns. So, if our previous paper wasn't enough to persuade you to take a close look, we hope that now you will feel confident pounding the table for small buyouts.

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All data is as of April 2024 unless otherwise noted.

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