Why Now’s the Time to Lean into Small Market Buyouts

Michael Venne (MV): [00:00:00] Concerns about inflation remain front of mind for investors. And even though monthly inflation was up in January, by and large, the Federal Reserve has managed to bring rates down without plunging the US into a recession—a so-called soft landing. Still, investors are hunkering down.

When the economy shrinks, institutions respond by changing the tilts of their portfolios. They shift capital to defensive asset classes like real estate and private debt, and they seek reassurance from larger, more established private equity fund managers. Necessarily [00:00:30] flocking to the familiar, as it is known, comes at the expense of small, emerging and by extension, diverse managers, which some regard as riskier than their larger, “more proven” counterparts. By doing so, these investors treat private equity, small market, which we call SBO, as a luxury good, something that is consumed with greater fervor when the economy is booming. Instead, we think they should consider it a staple that can benefit their portfolio regardless of what's happening at the macro level. [00:01:00]

And so we encourage investors to fight the urge to cut back on SBO. And if anything, we think now is the time to lean in. Joining me today to discuss why is Daniel Krikorian, a principal on our private equity team.

MV: Dan, welcome to RPM.

DK: [00:01:14] Thanks, Mike. Glad to be with you and excited to talk about our recent whitepaper, talking about fighting the urge to cutting back on small buyouts. There is a lot to talk about, so let's dive in.

MV: Let's do it.

MV: [00:01:26] So in our paper, we make the case that now is the time [00:01:30] to lean in, outlining several compelling reasons. Dan, could you double click on some of these components that underpin the thesis, specifically the opportunity set, some of the attractive features of SBO and SBA's outperformance potential?

DK: [00:01:45] Absolutely. I'll try and do the CliffsNotes version, but this might be a longer answer given there are numerous things that we think are attractive about small buyouts in the current environment. But maybe first, just to talk about why we wanted to [00:02:00] highlight this opportunity with our clients and LPs at this time in the market.

I think first, obviously there's macro uncertainty about the future of interest rate policy and what that might mean for recession and obviously on capital flows in private equity. Naturally, LPs are talking about the denominator effect within their portfolios. And so, a lot of those planning [00:02:30] discussions and exercises take place at the end of the year. That sort of bleeds into the middle of or the beginning of the next year. So we thought it was an optimal time to engage on this topic.

But I guess first, what is our thesis? So, as you sort of summarized at the top, we're arguing that allocators should resist the temptation to pull back from small buyouts and instead view it as a staple that can bolster and diversify [00:03:00] their portfolios regardless of the macro backdrop. Before I talk about sort of the rationale and the characteristics that we like about small buyouts, let me just first define what we call small buyout funds.

So that is a private equity fund raising less than $1 billion. And typically investing in companies with the total enterprise value of $250 million or less. And a common metric is typically EBITDA. [00:03:30] So these are typically companies with less than $25 million of EBITDA. Often these are, founder or family-owned businesses that might have, single digits of EBITDA. It is a very deep universe in the private equity market of institutional quality GPs globally. But, for the purposes of our whitepaper and our focus here, we're focused on North America. So, there's really hundreds and potentially thousands of GPs that fit that those [00:04:00] parameters. And it's a segment of the market that's highly specialized, meaning the GPs, may focus on a specific industry or a specific region or, may have unique value-add capabilities. So that's a quick definition.

In terms of characteristics of small buyouts that we find compelling. And these are, these are common throughout market cycles. But I think some are even more attractive in today's [00:04:30] market. First is just the capital to opportunity set. So the data shows that the small market is home to roughly 90% of private companies in the United States, yet only represents a fifth of total capital raised for buyout strategies. And we and most LPs track the dry powder metrics over time. [00:04:56] And so when you look at the different tranches of the buyout market. It, [00:05:00] as well as venture and growth, growth, equity, small buyouts have had the slowest sort of growth rates of dry powder over the last 5 or 10 years. So that sort of speaks to where LPs have been allocating over that time period. So a lot of the capital has flowed either up market to mid large and mega buyout funds or before the correction of the last 12 months, a lot was [00:05:30] flowing into venture capital and growth equity. So there are a lot of companies to invest in in the small market and small buyout funds have generally raised less capital. So that's an interesting dynamic which I'll circle back to.

The second point is really the focus of, of the firms, which I alluded to, the specialization is more likely to be present at the lower end of the market than at the upper end of the market. And particularly interesting is, [00:06:00] is just the inefficiency in the small market— the way deals are sourced, more direct sourcing outside of formal broad auctions. So small buyout firms really can generate value at entry on the buy.

Third is the operational value add opportunity. [00:06:21] I think anyone that's been around the private equity world, over the last 10 years has seen operating capabilities. That's really [00:06:30] table stakes now in the industry. So it’s very rare that we come across established GPs that don't have either a fully built out in-house operating team or a network of operating partners that they leverage to add value either during the due diligence phase or post investment in the value creation phase. So that's not unique to small buyouts. But what I think is, is just the lower hanging [00:07:00] fruit opportunities to professionalize these smaller, often family founder owned companies that have historically been resource or capital constrained and thus, the investment from a small buyout firm coupled with the capabilities with, in-house experts or specialists in certain things like technology, improving systems, the opportunity to upgrade or build out management teams, I think that really can turbocharge [00:07:30] a business. And those are those are opportunities that are present throughout market cycles.

Next is leverage. Leverage is obviously a common talking point with just the cost of debt having increased dramatically recently and just the availability of leverage in terms of the quantum that's available in the market. So small buyout firms typically use less leverage [00:08:00] and are less reliant on financial engineering to generate returns. That's especially relevant with the current debt market conditions where debt is tougher to get and more expensive across the board, which results in interest expense that eats deeper into a company's free cash flow. So the ability to, source smaller amounts of debt from a lender universe that is really more relationship focused at the smaller end of the market, think sort of regional [00:08:30] commercial banks versus, at the larger end of the buyout market, you're typically broadly syndicating loans amongst large national and international investment banks. So the lender universe that small buyout firms traffic in is much more flexible and sticky in times of dislocation like we're experiencing now.

And last but not least is something we talk about a lot as a small buyout investment team is the opportunity for multiple expansion. [00:09:00] And this is really a function of increased scale. So when an investment starts at perhaps $10 million of EBITDA and is able to grow to $20 million, you're entering a segment where there's just going to be more buyers, more potential buyers who will look at that as an attractive investment where they maybe wouldn't have when the business was smaller. Second, asset scarcity. So often when small buyout firm sells an asset [00:09:30] to a larger private equity firm, that's viewed attractively from the standpoint that the business has been professionalized to a certain extent. So there's less requirement right off, right out of the gates from the buyer to sort of do a lot of the work that the small buyout fund has already done. And third, what I alluded to earlier was just the dry powder and the competition up market. And so when you sort of combine all [00:10:00] the different things that I that I just mentioned the capital to opportunity set the greater focus on the inefficiency at the lower end of the market, the opportunity for lower hanging fruit value creation, lower leverage and the multiple expansion you can generate when things go well and a business can achieve that scale premium that can all combine to just really solid returns on [00:10:30] a deal-level basis—we often say home run potential.

So in our paper, we have some analysis of the realized North American buyout deals that we track in our system that generated over a 10X outcome. And there's 387 deals that meet those criteria, which was a much higher number than we would have thought. When you unpeel what type of funds those 387 realized, [00:11:00] 10X deals were in, 77% were in small buyout funds, which we think is quite compelling.

MV: [00:11:07] Yeah, that's really astounding. And I'm glad that you have brought up PE's outsized return potential because historically when investors thought about PE, right, they focused on the return potential. It's maybe it's direct alpha relative to public equities, but we found there's an equally compelling defensive reason. What makes SBO less sensitive [00:11:30] than larger buyout strategies to stock market volatility?

DK: [00:11:34] Right. That's a great point. There is sort of a misconception, I would say, in the market that small buyouts are just inherently more volatile or risky than their larger buyout brethren. And I think that misconception just stems from the fact that these are smaller companies; they have less margin for error in periods of market turmoil. So they are, [00:12:00], more likely to have volatile earnings and thus valuations are more likely to be volatile In the small market, we've actually seen the opposite.

So our analysis shows that small buyouts actually have lower asset level volatility than their larger buyout brethren to two swings in the public equity markets. And I won't go too deep into the analysis we ran, but it's in the whitepaper essentially. We [00:12:30] looked at the three most recent sort of market crash and recovery cycles the: dot-com bubble, the global financial crisis, and then Covid-19. The results were fairly consistent across all three cycles when we looked at the peak to trough of valuations across the public markets and the different tranches of the buyout world. On average, we found that small buyout funds captured roughly 30% of the public market downside and 94% of its upside. But [00:13:00] importantly, by contrast, the mid/large/mega buyout valuations captured closer to 70% of the public market downside. So much more volatile on the downside than small buyout. So, we asked why is this? And a few things, a few potential reasons for this came to mind that could make sense.

DK: [00:13:22] So there are several factors that may explain why small market funds are less sensitive to fluctuations in equity markets.

The first [00:13:30] is assessing public comps. Over time, the public markets have skewed more towards larger businesses. So, when a small buyout firm is looking to value their liquid asset, they're going to look at the public comps, and if there's a highly relevant direct public comp that will be factored into their valuation methodology. But often, there are less relevant public comps, especially when you sort of consider on a relative [00:14:00] basis, larger buyout funds are often able to comp to highly relevant sort of direct comps in the public markets. So, it would be hard for larger buyout funds to argue against taking a similar mark on a business that is very similar of size and scale in the public markets.

The second factor is just a subjective sort of old school conservatism. Many of these small buyout firms, have one strategy, one product—they raise funds every couple of years and they just prefer to under promise and over deliver. So interim valuations do not necessarily matter quite as much. And they are happy to have multiple expansion when they ultimately sell a business. And many of their LPs are, aware of that and comfortable with that fact. I think we're seeing more and more a preference amongst [00:15:00] LPs that funds attempt to mark their assets as close to market as possible, but nevertheless think it's common within small buyout to see just a bit more subjectivity within the illiquid valuations, which can play out in nice pops at exit but interim returns that are a little bit sandbagged in some cases.

The third factor is that small buyout funds just tend to [00:15:30] be less active fund raisers. These are GP's that typically have one strategy and raise funds every handful of years. So therefore, they're not as focused on interim valuations as say a larger private equity firm or asset manager that has multiple strategies and raises capital more frequently and obviously is more focused on interim returns.

And then the last is thinking about incentives in terms of management fees and carried [00:16:00] interest. In our experience, small buyout funds, just given the nature of their size, are more focused on carried interest than management fees. And so, they care more about exits than sort of interim marks because it doesn't really influence the, the scope of the management fee streams. So, think many LPs would understand that it's optimal for a sponsor to be aligned through the carry [00:16:30] of strong performance then management fees. So, all of those things contribute to more stable valuations and the small buyout world during periods of market turmoil, which is another benefit of small buyout exposure in a diversified investment portfolio.

MV: [00:16:46] So now that we have covered some of the arguments in favor of SBO, Dan, would you walk our listeners through the challenges that SBO can present?

DK: [00:16:54] Sure. Fundamentally, small buyouts are a riskier segment because of the dispersion [00:17:00] in returns between poor, decent and very good managers. The benchmarking data for North American buyout funds, for example, indicates that small buyouts have the greatest potential for outperformance, but also for underperformance. Further, the interquartile spreads are widest for small buyouts, as are the *intraquartile* spreads. So, this speaks to the importance of manager selection, which requires broad coverage and expertise to parse the landscape because [00:17:30] the benefits or drawbacks of moving either up or down, even a decile can be material.

MV: [00:17:36] So to recap, SBO represents this large investment opportunity that remains inefficient, relatively few dollars chasing many companies. And as a result, the upside potential is high. But the risks can be greater. And the trick is backing the right managers, which entails a cost, time, money and otherwise. Dan, can you put on your CIO hat for a moment and walk me through your benefit cost [00:18:00] analysis for determining whether SBO is worth the incremental effort it might take to identify a great manager?

DK: [00:18:10] Great question and something we did some in-depth analysis on in the whitepaper using our database of private equity returns, both fund and investment level.

So, to help LPs determine whether they should attempt to dedicate resources towards covering small buyouts, we compared the hypothetical [00:18:30] spread of performance one might expect from assembling portfolios of either brand name or small buyout funds. And we defined a brand name as a fund size in the top tercile (so the 67th percentile) for a given vintage. Therefore, small buyouts were defined as the bottom tercile (or 33rd percentile). So, taking a step back, obviously all LPs are constrained by time and resources. If you don't have either, it is best to [00:19:00] randomly select brand name managers because the downside risk is lower from picking poor managers. However, if you can commit the time and the resources, you can differentiate between good and not so good managers. So, the data shows that the marginal return on that effort, if it's committed, is higher in small gifts. In fact, the small buyout portfolio only needs to beat the 40th percentile to justify the effort. And if you pick better, the marginal benefit [00:19:30] grows incrementally. So that is fundamentally our approach to the small buyout landscape at StepStone is we seek to maximize exposure to the top quartile and just as importantly, to minimize exposure to the bottom quartile.

MV: [00:19:44] That's really neat stuff. Finally, and certainly not least, I would like to talk about diversity. Despite a growing corpus of work that illustrates the benefits of diversity on team, organizational, or investment performance, diversity in asset management remains the exception and not the rule. Can you explain this paradox and how it ties into SBO?

DK: [00:20:07] Sure. Well, first, I think in recent years you've seen good progress on more capital being available for diverse lead managers, and I think that's thanks to many larger influential LPs that have used their allocations to private equity to drive change. And importantly, they have done so without having to sacrifice [00:20:30] on investment performance. And that has also been our experience at StepStone, where our diverse manager track record in private equity has actually outperformed the benchmark median. But taking a step back, what is the opportunity set to invest in both diverse and emerging managers?

First, it is a very ripe opportunity, especially over the last five years, as you've had many new managers to spin out, and generally capital has been available for those new firms. [00:21:00]

Second, the ranks of diverse managers have also grown as diverse individuals have ascended into leadership positions at GPs. So, a little bit more into the numbers of where diverse managers reside within private equity: According to our data, roughly 75% would be considered emerging managers, meaning they're raising funds one, two or three, and 90% raise funds that are less than $1 billion. So, if LPs are looking to access diverse buyout managers, small buyouts is really the best place to access them. And importantly, now is an important time for diverse managers. There is the potential that the recent momentum of capital availability will stall if LPs don't proactively allocate. And so, our thesis with the whitepaper to [00:22:00] fight the urge to cut back on small buyouts could equally have been titled “Fight the Urge to Cut Back on Diverse Managers.”

MV: [00:22:07] Dan we have covered a lot of ground. Before I let you go, is there anything else we missed that you would like to cover?

DK: [00:22:13] Sure. Maybe one observation and one comment. The observation is something we have seen over the last five years. We talked about significant dry powder up market, and that is also partly due to the fact that many firms that we would have historically called small buyout have had success and raised larger funds and scaled up market—so have effectively graduated out of the small market. Yet these same funds are now returning to the small market and raising dedicated small cap funds, recognizing the inefficiencies and alpha opportunity in the small market.

And the comment is, as we think about our recommendation to LPs to fight the urge, hopefully we can sway some LPs to give small [00:23:00] market buyouts additional thought when assessing where to allocate in the years ahead. We certainly won't be able to convince the entire market to do so. So there will naturally be fewer LP dollars chasing the space in the years ahead. And for those LPs that do fight the urge, and proactively allocate, there's an opportunity to access very high-quality managers that previously would have been inaccessible when capital was more prevalent. So in my opinion, there's no [00:23:30] better time than now to lean into small buyouts.

MV: [00:23:32] Dan, thank you so much for joining us today. Be well and looking forward to seeing you again soon.

DK: [00:23:38] Thanks, Mike. This was great.

MV: [00:23:39] That does it for this episode of RPM. To download a copy of the whitepaper Dan mentioned, head to our website at stepstonegroup.com. RPM is available on Apple Podcasts, Spotify, Stitcher and other podcast platforms.