

Apple was a middle market company once

October 2015

Capturing the growth potential of the mid-market private equity universe

- ↳ Private equity provides investors with access to opportunities that are unavailable in the public markets
- ↳ It is in the middle market, rather than among the biggest companies, that deals with the highest return potential are to be found
- ↳ However, a highly selective approach is vital to find the best companies in the middle market and avoid the banana skins
- ↳ Specialist investors are best placed to source, analyse and invest in the most attractive middle market deals across the world



Federico Schiffrin
Investment Director,
Private Assets

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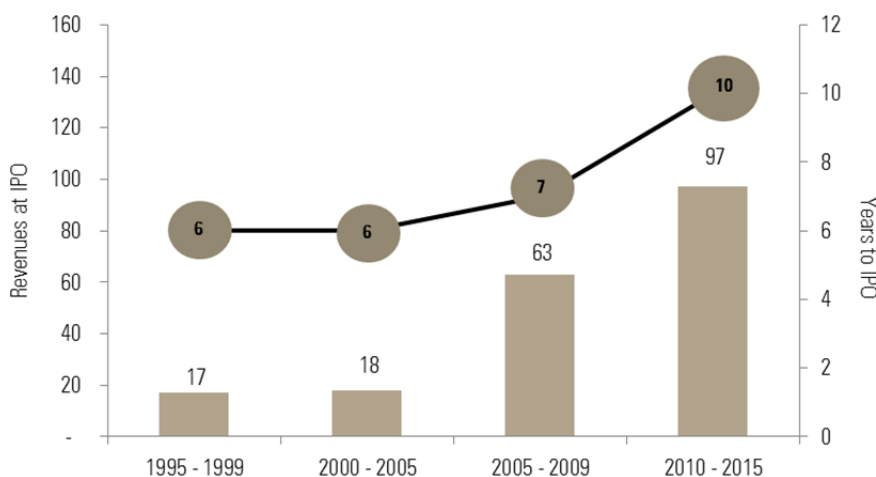
Thousands of what are now very successful large cap companies from across the world spent most of their existence in the middle market – that is, the universe of companies valued under USD 1 billion. And today, much of what we consume, be it goods or services, is developed, produced and delivered by companies in this segment – in fact, according to the Small Business Association, almost 50% of output in the US originates from small and middle market companies.

However, for investors, accessing the growth potential of small and middle market companies has historically been a challenge, as such companies are typically unlisted on public stock exchanges. Investing in private equity can therefore be an attractive way to gain access to the high potential returns of smaller companies.

Capturing value in the private markets

Investors who stick to publicly listed equities may be increasingly missing out on return potential. Chart 1 below shows the example of the tech industry, in which, since the 1990s, companies have been remaining private for longer and growing to a larger size before undergoing an IPO. The obvious implication of this is that by the time such companies go public, a significant proportion of their growth potential has already been captured, in many cases by private equity investors.

Chart 1: Tech companies remaining private for longer



Source: Bloomberg, FactSet, VC Status Research, Coatue

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The benefits of middle market private equity

The concept of private equity often brings to mind the mega-deals that have historically hit the headlines – but in our view it is in the less well publicised small and middle market that some of the best value is to be found, as we describe below.

Breadth of opportunity

First, the small and middle market is very broad, with a huge range of investment opportunities: we estimate that there are around 500,000 investable companies in the small and middle market around the world, and this figure grows each year. Within such a wide universe, there clearly exist a large number of companies with huge growth potential but that are not currently broadly known among investors – the challenge, of course, is finding them.

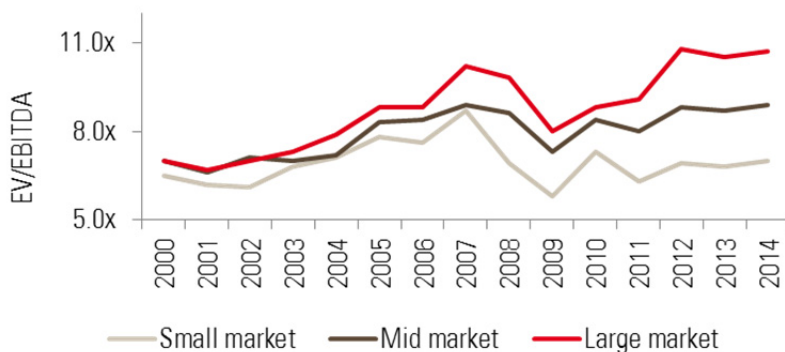
To date, private equity investors have been able to find and help companies in this segment become great companies, moving them up the ladder in terms of the breadth and depth of their products and their operational efficiency, and ultimately helping them realise their full growth potential. A few examples of companies that are household names today, but that have gone through significant transformations while under private equity ownership, include entertainment companies (The Blue Man Group), luxury brands (Oscar de la Renta in the US and Moncler in Italy), fast-casual eateries (Pret a Manger and Wagamama in the UK), airlines (Gol in Brazil) and even spirits (Oriental Breweries in Korea), which, having started as small companies in their respective markets, have grown to become a part of people’s daily lives.

Attractive valuations

Second, transaction prices in the small and middle market are often more attractive than those of larger companies as this segment is less intermediated, with a lower proportion of deals going through a competitive sales process. On a multiple of EBITDA basis, small and middle market companies can have valuations as much as 50% lower than comparable larger private companies. For example, in 2010, J. Crew, a well-known US retail company, was taken private for USD 3 billion, or 9.6x EBITDA. But in 2011, a smaller company from Europe called Scotch and Soda, growing more quickly and now taking market share away from its larger competitor, was bought for about USD 400 million, equivalent to 6.7x EBITDA. The larger business is now struggling, while the smaller firm has grown its EBITDA by 50% since its acquisition.

Chart 2 below shows how the acquisition multiples of companies in the small and middle market have been consistently below those of larger companies since 2000.

Chart 2: Small and middle market companies acquired at lower multiples



Source: S&P Capital IQ

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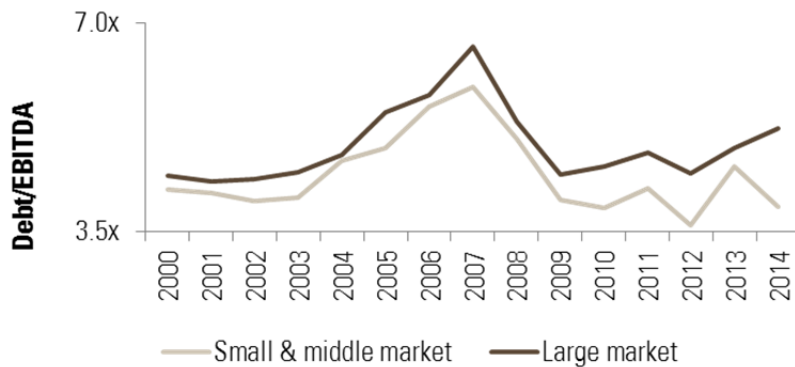
Why does this price arbitrage exist? First, it may just be because the smaller companies are not so well known, and therefore overlooked by a majority of private equity capital providers. In addition, there is less capital chasing a larger market: in 2014, USD 32 billion was raised by North American private equity firms to invest in the small and middle market, while USD 151 billion was raised to invest in the large cap market¹. But there can be negative reasons too – smaller companies may be less efficiently run, have a less attractive product range, or involve more risk than larger companies in the same sector. A talented private equity manager will be able to help such companies solve these problems and increase in value.

Lower leverage

Middle market companies have historically carried around 20% less leverage (on a multiple of EBITDA basis) than similar larger companies as banks have generally been more reluctant to extend credit to smaller firms. The lower leverage multiples of middle market companies mean they involve slightly less balance sheet risk, but more importantly, that these firms are compelled to create value from “true” business growth and operational improvements rather than through paying down debt (which has historically been the way that many larger leveraged buyouts have created value). Once again, this is where talented private equity managers come in.

We can see in Chart 3 that the degree of leverage taken on by companies in the small and middle market has consistently been below that of larger companies.

Chart 3: Small and middle market companies use less leverage than larger firms



Source: S&P Capital IQ

Scope to improve operations

Many companies need better management teams and processes to help them grow, and this is in general much more the case for smaller companies than larger firms – this is often one of the reasons why smaller companies have been unable to increase significantly in size. When private equity investors take over, they generally will upgrade the management team to effect change, in areas such as improving sales efficiency, finding new markets or launching new products, ultimately seeking to improve the outcomes at the company.

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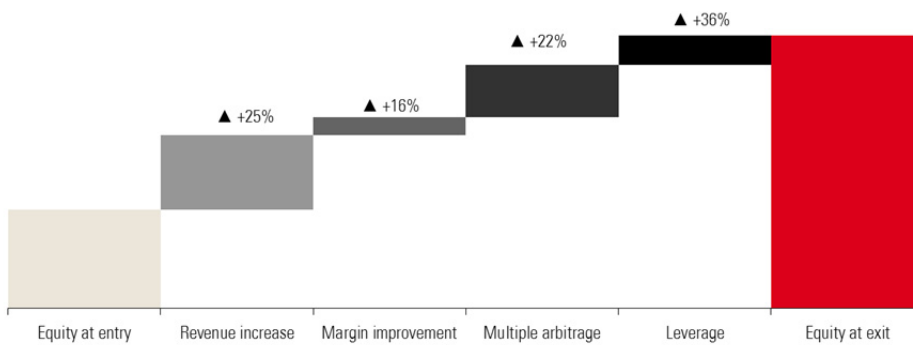
¹ Source: TorreyCove – “2015 Private Equity Market Outlook”



Properly executed operational improvements result in positive returns on capital as there is almost always someone at the other “end” of the deal seeking to buy a well-run company.

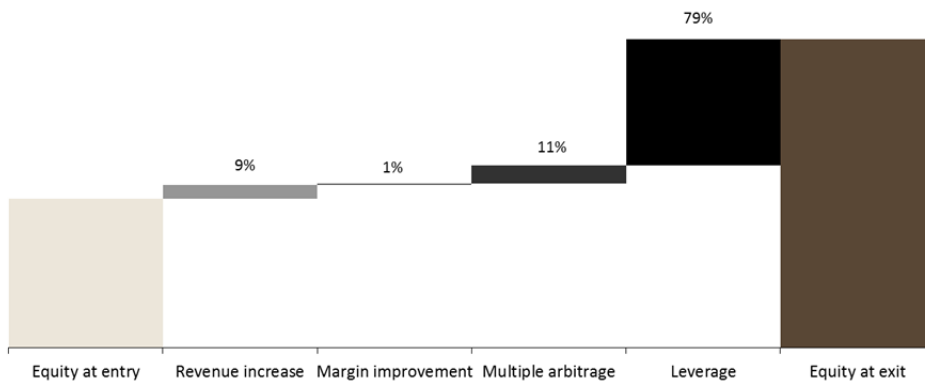
Chart 4 shows where a private equity investor typically creates equity value from a middle market company between acquisition and exit. Most of the added value (64%) comes from sales growth, margin improvements and multiple arbitrage (selling at a higher EBITDA multiple), while only 36% comes from the effects of leverage. This is in stark contrast to the typical large cap leveraged buyout, where on average 65–75% of the increase in equity value is the result of leverage, as Chart 5 shows.

Chart 4: Typical sources of value creation by a private equity investor in a middle market company between acquisition and exit



Source: Unigestion, based on data from companies in portfolio.

Chart 5: Typical sources of value creation by a private equity investor in a large cap company between acquisition and exit



Source: Unigestion, based on data from companies in portfolio

In essence, private equity investors in small and middle market companies accomplish their returns in substantially different ways to investors in large cap companies – middle market investors focus on real operational improvements that result in better companies, while many large cap investors rely mainly on financial engineering and market-driven forces.

Better historic returns, but with more variation

As a result of all these factors, private equity returns in the small and middle market have been considerably in excess of those at the larger end of the market, by as much as 500 basis points over the last 20 years.

While the better overall returns in the small and middle market can be explained by the previous arguments, one very important issue is masked by these figures: the dispersion between the best and worst companies in this segment of the market is much wider than in

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the large cap market. The difference in returns between a top-quartile and bottom-quartile performer is 7% in the large market, but 17% in the small and middle market. This suggests that in the larger market, company performance is more tightly clustered around an average, while at the smaller end of the market performance can vary significantly, increasing the need to be highly selective in the choice of investments.

Finding the investment opportunities

How can investors find the best middle market companies amidst the vast number in the universe? An important consideration is that nowadays they need to look across the world for the best opportunities – not just in the developed markets of the US and Europe. But in doing so, they need to think about how these companies operate in the context of their local market – what we call the “source global, think local” approach. Under such an approach, sourcing investment opportunities into companies globally should be done in partnership with the most experienced local investors and sector specialists, which we believe increases the probability of finding the best companies, while reducing overall execution risk. In our view, this approach sets the stage for successful, global middle market investing.

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Secular growth potential or short-term fad?

Successful private equity investors need to be close to the markets in order to differentiate secular trends from short-term fads. For example, after the Fukushima nuclear disaster in 2011, Japan banned the use of nuclear energy, resulting in a dire need for locally generated power, particularly from renewable sources, as the country suddenly had to import close to 100% of its energy. This was clearly going to lead to long-term opportunities for mid-market companies involved in renewable energy.

In contrast, countries such as Spain have aimed to meet renewable energy targets in the past, but there has been no overriding urgency for them to meet their goals, as they could always fall back on traditional sources of energy. This increases the risk that renewables companies in such countries will fail to grow significantly over the long term.

This is the first thing private equity investors should be acutely aware of: where possible, they should invest in areas that promise long-term growth, as opposed to companies exposed to themes that are “hot” at the time of investment but have no clear drivers in place to ensure that the growth is sustainable.

The ability to source investment opportunities and analyse companies across the world has helped private equity firms find companies such as Alibaba in China, Arcos Dorados in Mexico and Brazil, Wagamama in the UK and many others that are today big names in the global markets. So a successful private equity investor needs eyes on the ground in Asia, Europe, the US and elsewhere as high-potential companies exist in all regions.

In-depth analysis to identify the best opportunities

Once a potential investment opportunity, preferably that is set to benefit from a long-term trend, has been identified, how can investors determine if it is worthy of investment? Each company needs to be subjected to a rigorous selection approach using quantitative and qualitative filters to discern the health and viability of its business.

At Unigestion we have developed a proprietary scoring tool that helps us assess 13 relevant quantitative and two qualitative measures for each company that we analyse, and it automatically turns down the opportunity to invest if the company’s weighted score is below



a certain threshold. This screening also enables us to quickly and automatically identify red flags, such as high leverage ratios or poor growth, that would give us cause for concern about the firm and require us to dig deeper into the issue in question.

Avoiding overpaying for mediocre companies

Paraphrasing Warren Buffett, “it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price”. This mantra guides what we invest in – whereas other investors are sometimes willing to pay very high sums for companies of questionable quality, particularly in the large cap segment. We believe this kind of mistake can be avoided – through a selective approach to sourcing and with careful analysis, it is possible to identify medium-sized companies operating in expanding markets and providing goods or services with strong demand potential.

In conclusion, the universe of middle market investments is broad and global. Only specialist investors in this market can make handsome returns by selecting attractive, relatively difficult to find, inefficiently-run companies around the world which are poised to become leaders in their respective markets.

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