January 2024

Spotlight on Lower Middle Market Private Equity Pleasing Liquidity in a Challenging Market

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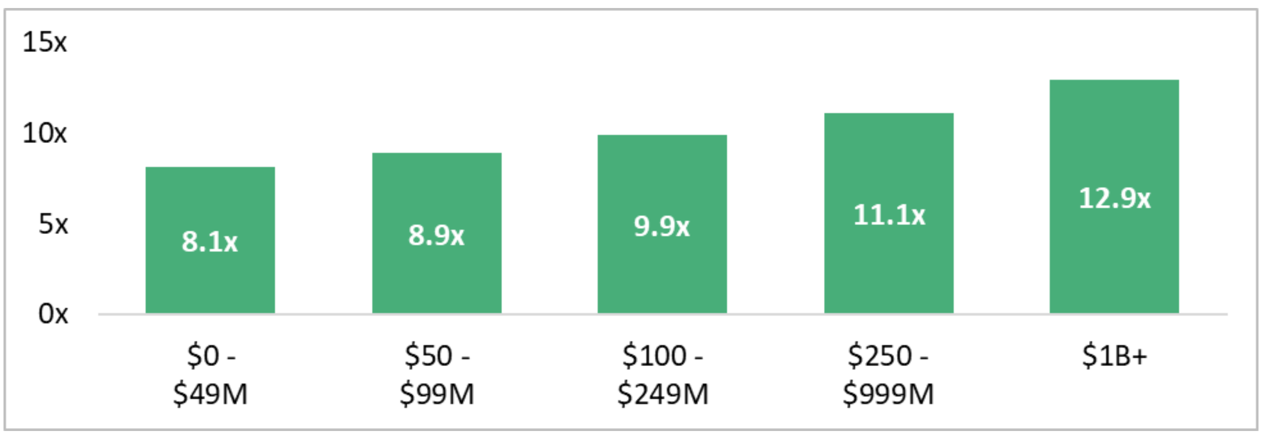
Do the benefits of lower mid-market (LMM) private equity hold up in a challenging environment?

Among savvy institutional investors around the globe, there is growing recognition of the benefits of a well-curated LMM private equity portfolio. Managers specializing in this part of the market benefit from several distinct advantages. First, the pricing of LMM deals tends to be lower than in other parts of the PE ecosystem, because there is a vast universe of small, privately owned businesses and a relatively smaller capital base pursuing acquisitions in that end of the market.

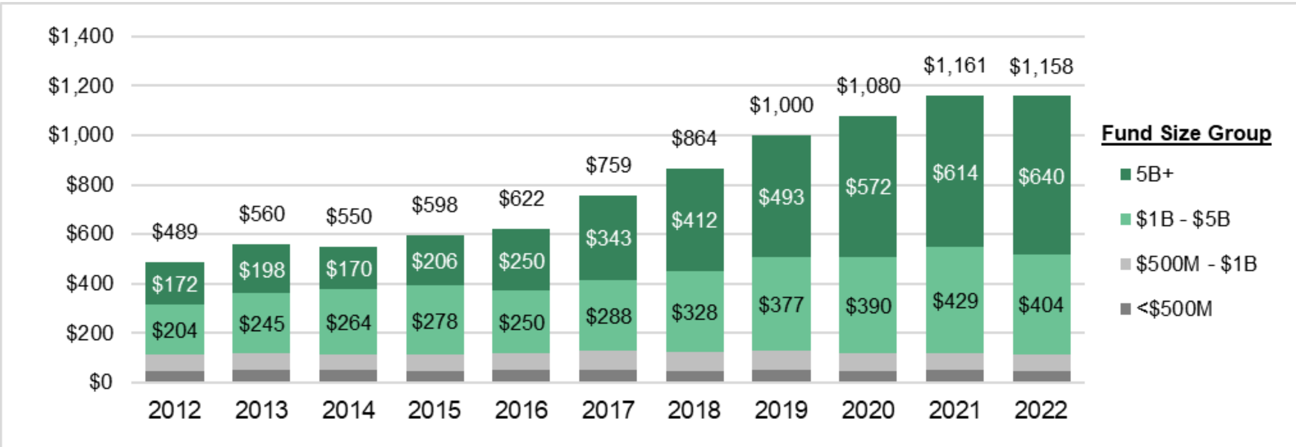
Figure 1: Global Median EV/EBITDA multiple, by target deal size at acquisition, 2010-22



Source: Bain & Company Global Private Equity Report 2023. Data from PitchBook, DealEdge powered by CEPRES data.

Lower entry multiples are not inherently more attractive entry points as they can be reflective of quality, of course. However, experienced LMM GPs are able to identify high quality assets for below-market valuations in this segment of the market where non-financial considerations tend to play a larger role in the seller's decision in selecting a buyer. After acquisition, LMM GPs regularly drive improvements and tend to do it quickly. When it comes to value creation, there is a lot of 'low hanging fruit' in smaller enterprises, often more than in larger businesses run by professional management teams. LMM GPs have ample opportunities to affect change and potentially generate significant upside in the businesses they acquire. Another consideration with LMM deals is the fact that they tend to use modest amounts of leverage, especially with companies pursuing an operationally intensive strategy. The reduced leverage levels help insulate portfolio companies from interest rate moves, a risk factor that had all but been ignored …until it quickly came back into focus!

Figure 2: Private Equity Dry Powder Concentrated in Large Cap Funds



Dry powder amounts in billions USD. Source: Pitchbook

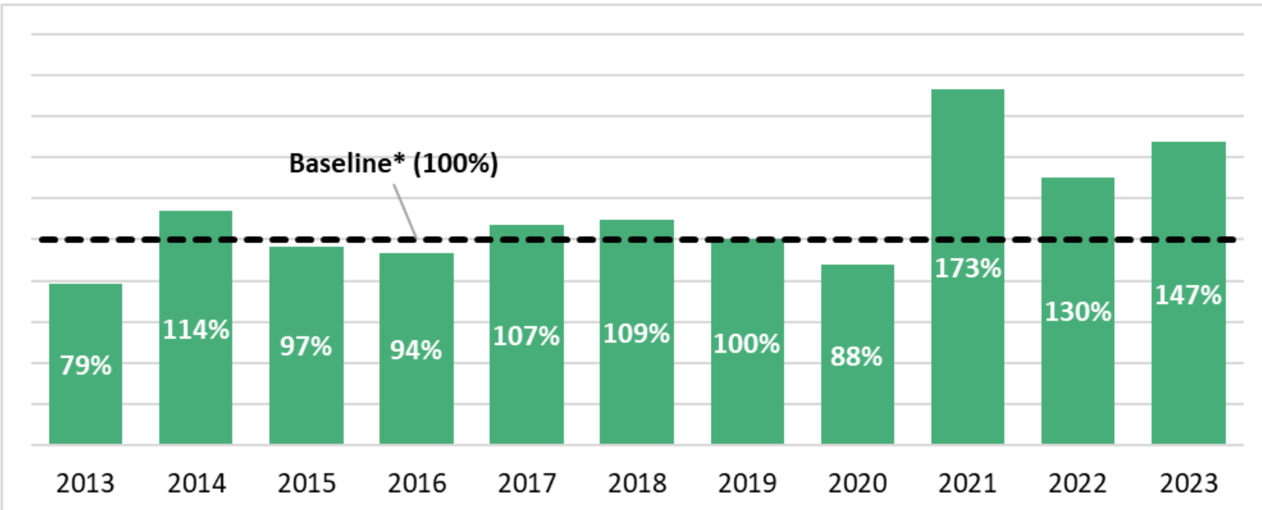
Finally, LMM managers have an attractive set of potential buyers for their assets, enjoying a broad, deep pool of buyers from strategic acquirers to the vast universe of financial buyers, many bloated with capital that they need to deploy and willing to pay higher multiples (see Figure 2). While these attractive qualities may be straightforward in the abstract, the question remains how do they hold up in a challenging environment like 2023?

The key measure - liquidity

Liquidity is the easiest, most impactful gauge LPs can use to assess their private equity investments. Ultimately, it is what we are all looking for from our private equity investments. Measures like TVPI and IRR are really just waymarkers in the life of a private equity program. In today's challenging environment, liquidity is top of mind for most limited partners. Many LPs have been lamenting anemic distribution activity in 2023. Pitchbook's Q3 2023 US PE Breakdown reported "The PE exit markets continue to show signs of fatigue, with both exit value and count remaining well below pre-COVID-19 averages."

By contrast, GroveStreet's LMM buyout portfolio has seen considerable liquidity in 2023, as presented in Figure 3 below. We are quick (and proud!) to acknowledge our portfolio is likely not representative of the broad LMM private equity market. GroveStreet's 2023 distributions *surpass* historical averages, including periods when the exit environment was more favorable. While strong liquidity in a given year can be the result of disproportionately large commitments in prior periods, that is not the case for GroveStreet as our year-to-year commitments have been steady for the past decade.

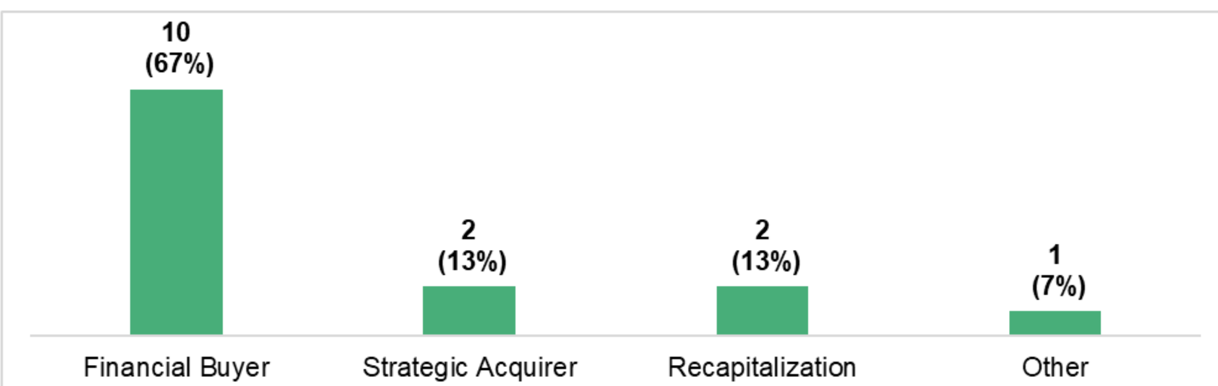
Figure 3: GroveStreet Distributions from LMM Buyout Funds + Co-Investments, as a percentage of baseline amount*



*The baseline average presented represents the average distributions for the period 2013-2019 and omits the distorted years associated with COVID-19 when there was abnormally low activity in 2020 and arguably excesses in the '21-'22 recovery years.

To understand the drivers for the strong liquidity for GroveStreet in 2023, it is instructive to examine the *character* of the year's top exits. Figure 4 presents the top 15 exits from GroveStreet's buyout portfolio in 2023. More than 2/3 were exits to financial buyers.

Figure 4: GroveStreet Top 15 Exits 2023 by Type



Note: Other is one investment where the sponsor divested non-core assets returning significant capital while retaining the core asset for future growth.

Intuitively, it makes sense that LMM buyout funds are still exiting companies to financial buyers even under challenging market conditions. As Figure 2 makes clear, there is a tremendous amount of dry powder within large cap private equity funds leaving many of them motivated to find compelling investment opportunities regardless of the market conditions. In challenging markets, financial buyers become more discerning, placing a greater focus on acquisition targets that demonstrate pricing power, resilience, and growth potential. Along with this flight to quality phenomenon, there continues to be interest in and competition for compelling investment targets, which continue to fetch attractive valuations. Furthermore, acquisitions of companies with an enterprise value of $250-750M (the size LMM buyout managers often look to sell) require considerably less leverage than acquisitions of companies valued in the $1B+ range. So, when debt markets are less supportive for large-scale, high-leverage transactions as they have been in 2022-2023, investors may see more distribution activity at the lower end of the market, if their portfolios have high quality assets to offer to the market.

While a one- or two-year fact pattern is hardly conclusive, it is encouraging to see the healthy, steady distributions from a well-curated LMM buyout portfolio. The attributes of strong LMM private equity funds – attractive entry multiples, ample levers for value creation, reduced exposure to interest rate risks, and attractive exit possibilities – afford select, talented GPs fertile opportunities to compound capital. GroveStreet will continue to focus on the LMM buyout segment, remaining highly deliberate and discerning in pursuing a select set of investment opportunities for our clients and our own capital.

Legal Information